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Section 1023 Carryover Basis: Planning Problems and Opportunities

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SECTION 1023 CARRYOVER BASIS: PLANNING PROBLEMS AND OPPORTUNITIES*

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I. BACKGROUND

With respect to individuals dying prior to January 1, 1977, the tax basis of most property in the hands of a person[1] who acquired it from a decedent was equal to its federal estate tax value,[2] that is, its fair market value on the date of the decedent's death or on the elective alternate valuation date,[3] without regard to the basis of the property prior to the decedent's death.[4] The basis of the property was thus stepped-up or stepped-down to its federal estate tax value for purposes of, *inter alia*, calculating any future gain or loss on a sale or other taxable disposition. For example, if property was purchased for $10 by a decedent and had a federal estate tax value of $100, a sale immediately after death in 1976 for $100 would not result in any gain for federal income tax purposes. However, if the property had been sold one day prior to the decedent's death the taxable gain would have been $90.[5] Thus, it was desirable to hold appreciated property until death so that no income tax would ever be realized on the appreciation during the decedent's life. It was also desirable for purposes of tax savings to sell loss property—property with a tax basis higher than its expected federal estate tax value—before death, so that the loss might be recognized.[6]

As of this writing, with respect to individuals dying after December 31, 1976, the provisions of section 1014 providing for a stepped-up or stepped-down basis at death are generally no longer applicable because of changes made by the Tax Reform Act of 1976.[7] Under new section 1023, with minor exceptions, property which formerly would have received a stepped-up or stepped-down basis at death will now have a carryover basis.

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[1] A "person" includes an individual, trust, estate, partnership, association, company or corporation. I.R.C. § 7701 (a)(1).

[2] I.R.C. § 1014. For purposes of this discussion of § 1023, property passing from a decedent shall be treated as acquired from the decedent. *See* I.R.C. § 1023 (g) (2).

[3] I.R.C. § 2032 provides an alternate valuation date at the election of the executor.

[4] Under certain circumstances property transferred by the decedent prior to death is included in the decedent's gross estate for federal estate tax purposes and its basis may be determined as if it were held by the decedent until his death. *See* Treas. Reg. § 1.1015-1(d) (1971).

[5] As the Joint Committee on Taxation noted in its General Explanation of the Tax Reform Act of 1976, this differentiation between a sale immediately prior to and immediately after death created a "lock in" effect. Elderly persons who could afford not to sell held appreciated assets until their deaths because of the substantial income tax advantage. STAFF OF THE JOINT COMMITTEE ON TAXATION, 94TH CONG., 2D SESS., GENERAL EXPLANATION OF THE TAX REFORM ACT OF 1976, at 552 (Comm. Print 1976), *reprinted in* 1976-3 vol. 2 C.B. 1, 564.

[6] If loss property was held until death, the application of § 1014 resulted in the property taking a new, lower basis equal to its depreciated value. The recipient of the property was thereby deprived of the opportunity to recognize the tax loss on a post-death sale.

[7] The Tax Reform Act of 1976, P.L. 94-455, 90 Stat. 1520 (Oct. 4, 1976) will be hereinafter referred to as the "1976 Act".

The decedent's basis in the property will carry over and will constitute, with certain adjustments, the basis in the hands of the person acquiring the property from the decedent.[8] Thus, appreciation in property value which used to go untaxed will no longer be exempt.

Legislation recently approved by the Senate Finance Committee may result in the deferral of the new carryover basis provisions so that they are only applicable to decedents dying after December 31, 1978 or December 31, 1979.[9] In any event, the new carryover basis rules, whenever applicable, create numerous estate, gift and income tax planning problems and opportunities for the tax practitioner. This article will attempt to illustrate these problems and opportunities by setting forth the technical rules of section 1023 and related sections and by considering certain planning techniques which may be utilized in dealing with the new carryover basis rules.

II. TECHNICAL CARRYOVER BASIS RULES.

A. *General*

New section 1023(a) provides that "[e]xcept as otherwise provided . . . the basis of carryover basis property acquired from a decedent dying after December 31, 1976 . . . shall be the adjusted basis of the property immediately before the death of the decedent" with certain adjustments.[10] Ignoring the adjustments for the moment, this new provision will result in $90 of income tax gain when a carryover basis asset with a tax basis of $10 immediately prior to a decedent's death and a federal estate tax value of $100 is sold for $100, regardless of whether it is sold prior to or after the decedent's death.

Section 1023(b)(1) defines carryover basis property for purposes of these new rules, with certain exceptions, as property which is acquired from a decedent within the meaning of section 1014(b). Under prior law sections 1014(a) and (b), with certain exceptions, provided that property included in a decedent's gross estate for federal estate tax purposes was treated as acquired from the decedent and received a stepped-up or stepped-down basis to federal estate tax value at death. Under prior law and under the 1976 Act various income type items and certain property disposed of prior to death were and are excluded from the application of sections 1014 and 1023 basis rules.

Among the assets excluded from the definition of carryover basis property are income in respect of a decedent, proceeds of life insurance on

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[8] I.R.C. § 1023(a).

[9] *See* the Technical Corrections Bill of 1977, H.R. 6715, 95th Cong., 1st Sess., as modified by the Senate Finance Committee in February, 1978. H.R. 6715 will be hereinafter referred to as the Technical Corrections Bill. A new version of H.R. 6715, now the Technical Corrections Bill of 1978, incorporating the Senate Finance Committee's decisions of February 1978 is presently being prepared. Outside of adding a provision which defers the effective date of the carryover basis rules, it is anticipated that this bill will follow the Technical Corrections Bill although the section references may be changed slightly by the provision added. *See also* S. 2227, 95th Cong., 1st Sess. (1977), postponing the effect of § 1023 until January 1, 1979.

[10] I.R.C. § 1023(a).

the decedent's life, certain annuities and certain payments under tax-qualified deferred compensation plans,[11] and certain property which is included in a decedent's federal gross estate by reason of sections 2035, 2038 or 2041[12] and which has been disposed of prior to the decedent's death in a transaction in which gain or loss is recognizable. These exceptions, in part, parallel the exceptions under prior law where a step-up or step-down in basis was not allowed and they continue the prior income tax treatment of items such as insurance proceeds and income in respect of a decedent.

In addition to the exceptions set forth above, section 1023(b)(3) provides a de minimis exception to the carryover basis rules for personal and household effects of the decedent which have a fair market value not in excess of $10,000.[13] This exception is applicable only if the executor makes a timely election.[14] To the extent that these items are not carryover basis property because of the election, section 1014 will be applicable and a federal estate tax value basis will apply.[15]

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[11] For further discussion of qualified pension plans under the 1976 Act see in this issue, Lidsky, *Lump Sum Distributions Under the Tax Reform Act of 1976*, P. 531 *infra*.

[12] Sections 2035, 2038 and 2041 deal respectively with (1) gift property transferred by a decedent within three years prior to his death, (2) property transferred subject to a power of revocation, alteration, amendment or termination in the transferor (alone or with others) and (3) property with respect to which the decedent has a general power of appointment at the time of or within three years of his death. For a discussion of the 1976 Act changes in § 2035, see in this issue, Note *Section 2035: Gifts Made Within Three Years of Death*, p. 577 *infra*. Under prior law if the donee disposed of property before the donor's death its basis was not readjusted (stepped-up) pursuant to § 1014 on the donor's death. *See* Int. Rev. Code of 1954, c. 1, § 1014(a), 68A Stat. 296 (now I.R.C. § 1014a). Prior law applied to both taxable and tax-free dispositions. Although § 1023(b)(2) is not clear on this point, it may be that certain property disposed of in a tax-free exchange will still be subject to the § 1023 adjustments.

It may be noted further that § 1023(b)(2) does not exclude from the definition of carryover basis property, property transferred by a donee prior to the decedent's death but included in the decedent's federal gross estate by reason of § 2036, dealing with transfers with retained life estates, or § 2037, dealing with certain transfers contingent upon the donee's surviving the decedent where the transfer is subject to a reversionary interest in the decedent.

[13] Proposed legislation may increase this figure to $25,000. *See* S. 2461, 95th Cong., 2d Sess. (1978).

[14] The election must be made no later than the date prescribed for filing the federal estate tax return under § 6075 (including extensions). Even though no specific filing period is prescribed under § 6075 for "small" estates (after 1980 these include estates under $175,000 as adjusted by certain post-September 8, 1976 gifts and post-1976 adjusted taxable gifts) which are not, pursuant to § 6018, required to file a federal estate tax return, presumably those estates will have at least nine months in which to file the election. When there is no court-appointed executor and the term executor refers to anyone in possession of property of the decedent (§ 2203), a spouse acquiring property from the decedent might make this election, although it is possible that conflicting elections might be made by other persons also acquiring property from the decedent. The question of how to resolve such conflicting elections remains unanswered.

[15] A second special rule exists with respect to carryover basis personal or household effects of the decedent to which the $10,000 election is not applied. *See* I.R.C. § 1023(a)(2). If these items have a high tax basis and low federal estate tax value, the basis will be the federal estate tax value for purposes of determining the loss on any sale by the person acquiring the asset from the decedent. Thus, if the federal estate tax value were $10, the basis were $25 and the asset were sold for any price between $10 and $25, there would be no gain or loss. This special rule as to losses is consistent with the view that if the decedent had sold these items before death any loss realized would not be allowed as a deduction to offset gains, since the loss would be personal.

The special provisions for personal and household effects are designed to alleviate the need for keeping detailed carryover basis records indicating whether or not gain or loss is recognized when personal or household effects of little value are sold. The election provision only will prove advantageous when personal and household effects[16] have appreciated in value and an election will reduce subsequent gain on a sale. Because an executor will no doubt have some obligation, unless otherwise provided by instrument, to determine which assets should be covered by the section 1023(b)(3) election and which high basis-low value assets should not, this special provision may not reduce his obligation to determine the basis of all personal and household effects. Thus, this provision designed to decrease the difficulties of administering an estate may in fact create an administrative nightmare. Such an increase in administrative complexity is hardly a welcome addition to the significant complexities section 1023 creates in the determination of basis.

B. *The Four Adjustments*

In determining the section 1023 carryover basis of property in the hands of a person acquiring it from the decedent, there are four adjustments which may increase the basis over the basis of the property in the hands of the decedent. The 1976 Act requires that the adjustments be made in the order discussed below.[17] It is likely, however, that the order of the adjustments will be modified, assuming that proposed legislation is passed to increase the minimum basis adjustment (section 1023(d)). This matter will be examined in greater detail below. In any event the order in which the adjustments are made will have a significant impact on the amount of each adjustment.

1. Fresh Start Adjustment—Section 1023(h)

Probably the best known catch phrase with respect to the carryover basis rules is "fresh start." The fresh start adjustment under the carryover basis rules constitutes a transitional rule which, while presently of major significance, will become decreasingly significant each year. This adjustment must be made before any other adjustments, both under the 1976 Act and under proposed legislative modifications.[18] It represents a rough attempt to continue the income tax benefits of pre-1976 Act law through December 31, 1976, the date prior to the effective date of the relevant provisions of the 1976 Act.

[16] Undoubtedly regulations will define when items such as coin collections and paintings will be treated as held for investment and not as personal or household effects. Also, regulations should permit an adjustment in the choice of assets subject to the election should there be a change in estate tax values resulting from an IRS audit or otherwise. Proposed legislation may clarify some of these matters.

[17] *See* I.R.C. § 1023(f)(2).

[18] One bill, S. 2228, 95th Cong., 1st Sess. (1977), would eliminate entirely the fresh start adjustment by grandfathering all assets held on December 31, 1976 so that the carryover basis rules would not apply to such assets. The Treasury is opposed to this approach which would allow post-1976 appreciation on grandfathered assets to escape from the new carryover basis rules. *See also* S. 1954, 95 Cong., 1st Sess. (1977), providing for total repeal of carryover basis.

The fresh start provision increases the adjusted basis of property which a decedent held or is deemed to have held on December 31, 1976 for purposes of determining gain, but not loss,[19] by the amount by which the fair market value of the property on December 31, 1976 exceeds its adjusted basis on that date. This adjustment reflects, in part, the equitable view that a person dying on January 1, 1977 should not be treated wholly differently from a person dying on December 31, 1976.

This adjustment is only to be used where it favors the taxpayer. Thus, if the basis exceeds the fair market value there is no step-down to fair market value as there was under prior law. For example, if the basis of marketable securities on December 31, 1976 is higher than their then fair market value, the basis, and not the December 31, 1976 value, will be used in determining gains from any post-death sales.[20]

The fresh start adjustment only is applicable to carryover basis property whose adjusted basis reflects the adjusted basis of property held on December 31, 1976.[21] Thus, the fresh start adjustment is not applicable to property first purchased after December 31, 1976. Carryover basis property held by a decedent from December 31, 1976 until his later death would be subject to this adjustment. The adjusted basis of carryover basis property also will reflect a December 31, 1976 basis and the fresh start adjustment will be applicable where property held on December 31, 1976 is transferred and its basis is determined to be, in whole or in part, either the same as it was prior to the transfer or the same as the December 31, 1976 basis of other property for which it is exchanged. For example, a gift of carryover basis property made after December 31, 1976 by a donor who held the property on December 31, 1976 would be subject to a fresh start adjustment on the donee's death[22] because the donee's basis in the property would reflect the donor's basis.[23] Similarly, property acquired in a tax-free exchange in return for property held on December 31, 1976 would reflect the basis of property held on December 31, 1976 and be eligible for the fresh start adjustment.[24] Thus, a tax-free recapitalization of a closely-held corporation should not cause a loss of a fresh start adjustment.[25]

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[19] Under some recent proposals the fresh start adjustment would apply for purposes of determining both gain and loss. *See, e.g.*, S. 2461, 95th Cong. 1st Sess. (1978).

[20] In this respect an individual dying on January 1, 1977 actually will be in a better position from a tax standpoint than an individual dying on December 31, 1976, because under prior law when the basis of an asset exceeded its value at death the basis was stepped down, precluding the recognition of a loss.

[21] *See* I.R.C. § 1023(h).

[22] If the donor died within three years of the gift, however, the property would be included in his estate by virtue of § 2035, and a fresh start adjustment would be appropriate at that time, assuming that the donee had not transferred the property in a taxable transaction prior to the donor's death. *See also* I.R.C. § 2035(b)(2) (relating to certain exclusions from § 2035).

[23] I.R.C. § 1015. See I.R.C. § 1015(d) for an adjustment in the donor's basis in the hands of the donee. It is likely that regulations with respect to the fresh start adjustment will adopt a concept similar to the holding period rules under §§ 1223(1) and (2), and where property has, in whole or in part, the same basis as it had on December 31, 1976, with adjustments for depreciation and the like, it probably will be deemed to reflect the December 31, 1976 basis.

[24] *See, e.g.*, I.R.C. §§ 333, 351, 368, 1031 and 1033.

[25] Directly related to the determination of which property reflects the basis of property held on December 31, 1976 is the question whether a fresh start adjustment can be made more than once either to the same property or to property which reflects the basis of property

(a) Marketable Bonds and Securities—Section 1023(h)(1)

Mechanically, the calculation of the fresh start adjustment differs for marketable bonds and securities as compared with other carryover basis assets.[26] For marketable bonds and securities the fresh start adjustment is equal to the amount by which the fair market value of such bonds or securities on December 31, 1976 exceeds their adjusted basis on that date.[27]

Section 1023(h)(1) provides that the fresh start adjustment for marketable bonds and securities applies where "the adjusted basis immediately before the death of the decedent of any property which is carryover basis property reflects the adjusted basis of any marketable bond or security on December 31, 1976 . . . ."[28] The term "marketable bond or security" is defined to mean "any security for which, as of December 1976, there was a market on a stock exchange, in an over-the-counter market, or *otherwise*."[29] Temporary treasury regulations[30] limit the scope of the definition—particularly the "or otherwise" language—by defining marketable bonds

as to which at least one fresh start adjustment has been made. For example, if X died in 1978 bequeathing to Y carryover basis property other than marketable bonds and securities held by X on December 31, 1976 and in 1980 Y died bequeathing the property to Z, it could be argued that two fresh start adjustments are appropriate, since on Y's later death the basis of the property still reflected, in part, the basis of the property on December 31, 1976. While the statutory language of the 1976 Act does not prohibit two fresh start adjustments with respect to the same property, the Joint Committee Explanation specifically states that only one fresh start adjustment is appropriate. STAFF OF THE JOINT COMMITTEE ON TAXATION, 94TH CONG., 2D SESS., GENERAL EXPLANATION OF THE TAX REFORM ACT OF 1976, at 555 (Comm. Print 1976), *reprinted in* 1976-3 vol. 2 C.B. 1, 567. Further, the Technical Corrections Bill would, pursuant to § 3(c)(3), add a new section to § 1023(h) to make it clear that only one fresh start adjustment is allowed. H.R. 6715, 95th Cong., 1st Sess. § 3(c)(3) (1977).

[26] The Joint Committee Explanation explains the genesis of this distinction. STAFF OF THE JOINT COMMITTEE ON TAXATION, 94TH CONG., 2D SESS., GENERAL EXPLANATION OF THE TAX REFORM ACT OF 1976, at 555 (Comm. Print 1976), *reprinted in* 1976-3 vol. 2 C.B. 1, 567. Since the purpose of the fresh start adjustment is to step-up (but not down) the basis of an asset to its fair market value on December 31, 1976, the first step is to determine the December 31, 1976 value. For marketable bonds and securities it is fairly easy to determine the value, since, by definition, see text at notes 29-32 *infra*, marketable bonds and securities are bonds and securities for which a public quotation exists. In the case of other assets for which December 31, 1976 valuations are not so easy to obtain, it was thought undesirable to require an exact determination of December 31, 1976 value. Requiring such an exact determination might force innumerable taxpayers to appraise a variety of assets which may or may not be included in the taxpayers' estates since they could be sold or otherwise disposed of prior to death. Alternatively, an appraisal at the time of death to determine accurately the December 31, 1976 value was highly impractical if the decedent died many years after 1976. To avoid this complexity and confusion, the determination of the December 31, 1976 value of assets other than marketable bonds and securities is made by assuming that all appreciation between the adjusted basis of the asset and its fair market value immediately prior to the death of the decedent in whose estate it is included occurred ratably over the days the asset was held. STAFF OF THE JOINT COMMITTEE ON TAXATION, 94TH CONG., 2D SESS., GENERAL EXPLANATION OF THE TAX REFORM ACT OF 1976, at 555 (Comm. Print 1976), *reprinted in* 1976-3 Vol. 2 C.B. 1, 567.

[27] I.R.C. § 1023(h)(1).

[28] *Id.*

[29] I.R.C. § 1023(h)(2)(E)(i) (emphasis added).

[30] 42 Fed. Reg. 39, 104-5 (1977) (to be codified in Temp. Treas. Reg. § 7.1023(h)-1). *See also* STAFF OF THE JOINT COMMITTEE ON TAXATION, 94TH CONG., 2D SESS., GENERAL EXPLANATION OF THE TAX REFORM ACT OF 1976, at 556 (Comm. Print 1976), *reprinted in* 1976-3 vol. 2 C.B. 1, 568.

and securities to mean (1) bonds, including municipal bonds, or securities which are (a) listed on the New York or American Stock Exchange or on any regional exchange for which quotations are published on a regular basis, including foreign securities listed on recognized foreign national or regional exchanges, (b) regularly traded[31] in the national or regional over-the-counter market for which published quotations are available, or (c) locally traded for which published quotations representing bona fide bid and asked prices are available from a registered broker or dealer; (2) units in a common trust fund; and (3) shares in a mutual fund.[32] Stock of a closely-held corporation subject to purchase at a fixed price pursuant to a stock purchase agreement and stock of a personal holding company, not publicly traded, whose only assets are marketable securities[33] fall outside the Treasury's definition of marketable bonds or securities. This is true despite the fact that both are arguably includible under the statutory definition of marketable securities because of the "or otherwise" language and because the statute, standing alone, would not appear to require a public market for a security to be marketable.

It is possible that certain marketable securities held by a decedent on his death subsequent to December 31, 1976 may not be subject to the fresh start adjustment for marketable securities, but rather may be subject to the fresh start adjustment for carryover basis property which is neither a marketable bond nor a security. This is because the character or marketability of the security owned on December 31, 1976, rather than on death, determines the applicable fresh start rule. For example, assume that stock of a closely-held corporation was owned by an individual on December 31, 1976. If in January of 1977 the corporation was acquired by a New York Stock Exchange corporation in a section 368(a)(1)(B) tax-free stock exchange, the basis of the acquiring corporation's stock received in the exchange would be determined by the basis of the closely-held corporation stock previously owned.[34] This basis would reflect the basis of carryover basis property other than a marketable bond or security on December 31, 1976. The fresh start adjustment for carryover basis property other than marketable bonds and securities therefore would apply.[35]

After it is determined which carryover basis property is subject to the fresh start adjustment for marketable bonds and securities, the value on December 31, 1976 of the appropriate marketable bond or security must be

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[31] The regulations do not define "regularly traded."

[32] *See* 42 Fed. Reg. 39,104-05 (1977) (to be codified in Temp. Treas. Reg. § 7.1023(h)-1).

[33] An argument might be based on E.I. DuPont de Nemours & Co. v. Collins, 432 U.S. 46 (1977) that the value of personal holding company stock is directly determined by valuing the underlying securities. In *DuPont* the Supreme Court upheld the SEC's valuation of an investment company based on the market value of the securities constituting virtually all of its assets rather than on the lower value of its own stock. *See id.* at 57. This holding may make it possible to argue that the personal holding company stock fits within the "or otherwise" portion of the definition of a marketable bond or security in cases similar to *DuPont* despite the temporary regulations.

[34] I.R.C. § 358.

[35] See text at notes 43-48 *infra*.

determined. The Joint Committee Explanation states that the valuation is to be made using normal estate and gift tax valuation methods.[36] It is likely that the valuation will be determined pursuant to principles which include allowances for factors such as blockage discounts.[37] For purposes of determining December 31, 1976 value, as opposed to federal estate tax values, the government, not the taxpayer, will argue for substantial blockage discounts.

Once the December 31, 1976 value is determined and assuming the basis of the security is known[38] the fresh start adjustment, applicable for purposes of determining gain, but not loss, can be made.[39] To illustrate, if a marketable security had a December 31, 1976 and date of death basis in X's hands of $10, and a December 31, 1976 value of $20, a fresh start adjustment would result in a basis of $20 for the purposes of calculating gain (the date of death basis of $10 increased by the difference between the December 31, 1976 value of $20 and the December 31, 1976 basis of $10). Thus, if the security were sold after X's death in 1980 for its federal estate tax value of $25, the gain, assuming no other adjustments apply, would be $5 (the selling price of $25 minus the basis of $20). If it were sold for $8 the loss would only be $2 (the selling price of $8 minus the pre-death basis of $10). A sale for any price between $10 and $20 should result in neither gain nor loss because section 1023 provides for an increase in basis only for purposes of determining gain.[40]

If, in the example above, the federal estate tax value of the property in X's estate were $18 and if it were sold years after X's death for $25, a question might arise as to whether the gain were $5 or $7. If the fresh start adjustment to December 31, 1976 value ($20) can cause the basis of the property to exceed its federal estate tax value ($18), the gain would be $5. If not, the gain would be $7. There is nothing in the statute which limits the fresh start adjustment to the federal estate tax value.[41] Indeed, the temporary treasury regulations set forth examples which indicate that the fresh start adjustment can cause the basis to exceed federal estate tax value. Thus, it would appear that the determinative figure for purposes of computing the fresh start adjustment is the December 31, 1976 value of $20 and the amount of gain to be reported in this example would only be $5.

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[36] STAFF OF THE JOINT COMMITTEE ON TAXATION, 94TH CONG., 2D SESS., GENERAL EXPLANATION OF THE TAX REFORM ACT OF 1976, at 556 (Comm. Print 1976), *reprinted in* 1976-3 vol. 2 C.B. 1, 568. Section 2512(a) provides that the amount of a gift shall be considered to be its value. Section 2512(b) provides that the amount of a gift given for less than adequate consideration shall be considered to be the difference between the value of the property transferred and the consideration received.

[37] The term "blockage discount" describes the fact that a large block of stock most often will be sold at a lower price per share than the market price for a sale of a small "normally traded" block. *See generally* FED. EST. & GIFT TAX REP. ¶ 1202.75 at 1019 *et seq.* (CCH 1977).

[38] The basis may not be easy to determine, if, for example, the property was purchased by someone else and given to the decedent or, if, in the case of stock, there have been numerous splits and the like.

[39] But see note 19 *supra.*

[40] See the similar rules under § 1015 and with respect to personal and household effects sold at a gain or loss, note 15 *supra.*

[41] All of the other three adjustments to be discussed in the text are limited so that they will not increase the basis of carryover basis property above its federal estate tax value. *See* §§ 1023(f)(1), (g)(1). The Joint Committee Explanation specifically excludes one sentence appearing in the Conference Committee Report of the 1976 Act, which stated that the fresh start ad-

(b) Carryover Basis Property Other than Marketable Bonds and Securities—Section 1023(h)(2)

(i) *Basic Rule and Application.* For purposes of determining the fresh start adjustment for carryover basis property other than marketable bonds and securities, it is generally assumed that all appreciation representing the difference between the value of the property on the date of death[42] (but not on the alternate valuation date) and its adjusted basis immediately prior to death, occurred at a uniform rate during each day of the period for which the decedent is treated as having held the property.[43] The fresh start adjustment is then computed by determining what proportion of total appreciation over basis occurred before January 1, 1977 and adding that amount to the basis immediately prior to death. For example, assume that X purchased on January 1, 1967 carryover basis property other than a marketable bond or security for $40 and held the property until his death on December 31, 1981 when its date of death value was $100. The fresh start adjustment would be computed as follows:

$$\frac{\text{3,650 (no. of days during period 1/1/67 through 12/31/76, ignoring leap years for simplicity)}}{\text{5,475 (no. of days during period 1/1/67 through 12/31/81, ignoring leap years)}} \text{ X \$60 (total appreciation)}^{44} = \$40$$

After the fresh start adjustment, the basis for purposes of determining gain would be $80: the $40 of original basis plus the $40 fresh start adjustment.

The 1976 Act requires knowledge of the basis of property when making the fresh start adjustment.[45] One Treasury proposal, incorporated in S. 2461,[46] provides a method for making the adjustment when the basis of nonbusiness personalty or a personal residence is unknown, as is often the case. A formula approach is used to reduce the date of death value to the

justment was also limited by the federal estate tax value. S. REP. NO. 94-1236, 94th Cong., 2d Sess. 612 (1976), *reprinted in* [1976] U.S. CODE CONG. & AD. NEWS 4118, 4251. This omission, however, seems inconsistent with the purpose of the fresh start adjustment. There is no reason to give the taxpayer a greater basis step-up through a fresh start adjustment than he would have had if the step-up in basis rules of prior law had continued to apply until his death.

[42] The special valuation of § 2032A is applicable in determining the date of death value if properly elected for estate tax purposes. The Treasury has suggested that federal estate tax value (taking into account the alternate valuation date) replace date of death value in this calculation. *See Legislation Relating to Carryover Basis Provision of Tax Reform Act of 1976: Hearings on S. 2227 & S. 2228 Before the Subcomm. on Tax. & Debt Management of the Senate Finance Comm.*, 95th Cong., 2d Sess. (Oct. 27, 1977) (Statement of Donald C. Lubick, Deputy Ass't. Sec. of Treasury for Tax Policy), *reprinted in* 208 DAILY TAX REP. J-4, J-7 (Oct. 27, 1977) [hereinafter Statement of Donald C. Lubick].

[43] This principle is slightly modified when property subject to an allowance for depreciation, amortization or depletion is involved as discussed in the text at notes 54-58 *infra*.

[44] Total appreciation represents the difference between the date of death value ($100) and the adjusted basis immediately prior to death ($40). The December 31, 1976 value and basis of the property is irrelevant to the calculation.

[45] See text at note 100 *infra* for a discussion of the present treatment of property with an unknown basis under § 1023(g)(3).

[46] S. 2461, 95th Cong., 2d Sess. (1978).

December 31, 1976 value, based on the assumption that the property appreciated at an annual interest rate of 6%. Under this formula approach the December 31, 1976 value may not be lower than 25% of the date of death value.

As is true with the fresh start adjustment for marketable securities, this adjustment will apply only if the adjusted basis of the carryover basis property immediately before the death of the decedent reflects the basis on December 31, 1976 of property other than a marketable bond or security. Again, care must be taken to determine what December 31, 1976 adjusted basis is reflected.

Under the 1976 Act, and presumably under any legislative modifications, in calculating the holding period of property for purposes of the fraction set forth above, the holding period of a prior owner may be tacked on if the decedent's basis for determining gain or loss continues to be the same, in whole or in part, as it was in the hands of the prior owner. Further, if prior to his death the decedent transferred property that is later included in his estate the holding period until the date of death may still be taken into account.[47] In sum, if Y in 1971 gave property he had purchased on January 1, 1967 to the decedent X, if within three years of his death, X in turn gave it to his son, S, and if S did not dispose of the property prior to X's death, the holding period would be the same as in the example above, that is, it would include the entire period from Y's purchase of the property in 1967 to X's death in 1981.

(ii) *Special Cases.* In determining the property which is subject to the fresh start adjustment of section 1023(h)(2) and the extent of the adjustment, section 1023(h)(2)(D) provides that substantial improvements, as defined by regulations to be issued, will be treated as separate property. Thus, if a substantial improvement is made after December 1976—perhaps when a new room is added to a house—that portion of the property which constitutes the substantial improvement would not be subject to a fresh start adjustment. Difficult computations may be required in making separate calculations where substantial improvements have been made. It is recommended that detailed records of all significant improvements made on, before, or after December 31, 1976 be kept, since at present it is not clear what the regulations will treat as "substantial improvements."

Certain unfortunate results are the product of a fresh start adjustment which assumes that appreciation occurs at a uniform daily rate over the period carryover basis property is held. The classic case is in the area of recapitalizations of closely-held corporations. Often preferred stock is issued to the older generation, which holds all of the stock of the corporation in an attempt to freeze the value of their interest in the corporation. The older generation then gives the younger generation all or most of the common stock, preferably giving all of the nonvoting stock and retaining the voting stock when two classes exist. By this device the future growth of the corporation, represented by the common stock, is passed on to the next generation at what is hoped to be little or no gift or estate tax cost.[48]

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[47] I.R.C. § 1023(h)(E)(ii).

[48] It is beyond the scope of this article to examine the changes to § 2036 under the 1976 Act and the proposed Technical Corrections Bill changes (§ 3(i)) which may be the first step toward limiting the use of family recapitalizations as an estate planning technique. For a

The effects of section 1023(h) on stock received in a family recapitalization are illustrated by the following example. Assume that father, F, holds preferred stock with a basis of $10 and a face and redemption value of $100,000 on December 31, 1976, that he founded the company and first received its common stock on January 1, 1967[49] and that he died on December 31, 1986. Even though the preferred stock received by F in 1975 in an income tax-free recapitalization of the corporation had a value on December 31, 1976 of $100,000 (ignoring any discounts from redemption and face value of $100,000 based on dividend return, etc., which might be asserted in gift or estate tax proceedings) and did not appreciate in value after that date, it will still be assumed that appreciation occurred at a uniform daily rate over the twenty years or 7,300 days (ignoring leap years) included in the preferred stock's holding period.[50] Thus, under present law, on F's death only one half of the appreciation over basis of $99,990 ($49,995) representing the portion of the total holding period which is prior to January 1, 1977, will be added to the basis of the preferred stock. If after F's death in 1986 the corporation redeems all of the preferred stock pursuant to section 303[51] for the stated value of $100,000 there will be $49,995 of gain, assuming no dividend exposure and ignoring any other adjustments to basis. Section 1023 indicates that the special fresh start calculations, assuming daily pro rata appreciation, must be used even if an executor can establish that the December 31, 1976 fair market value is other than the value determined under the special valuation method.[52] Proposals have been made to modify this result, particularly with respect to nonvoting, nonconvertible preferred stock outstanding on December 31, 1976 and stock subject to a binding buy-sell agreement on that date. It is not clear, however, whether any of these proposals will become law.[53]

(iii) *Depreciable Carryover Basis Property.* The fresh start adjustment for property other than marketable bonds or securities becomes slightly more complicated if property subject to depreciation, amortization or depletion is involved. In the example above,[54] dealing with property with a basis of $40

fuller discussion of those changes, see in this issue Corneel, *Effect of the 1976 Tax Reform Act on Stock Buy-Out Agreements and Other Close Corporation Plans*, p. 509 *infra*.

[49] It is also assumed that the enterprise did not exist in any form prior to January 1, 1967. If it did and the corporation was established in a § 351 exchange, the holding period of the assets transferred to the corporation would be taken into account in determining the holding period of both the common and preferred stock for purposes of the fresh start adjustment. I.R.C. § 1023(h)(2)(E)(ii).

[50] *See* § 1023(h)(2)(E)(ii) (defining "holding period"). On the recapitalization the basis of the preferred stock received would be determined by the basis of the common held prior to recapitalization, and the holding period of the preferred would include the holding period of the common. I.R.C. §§ 358, 1223(1).

[51] See the discussion of § 303 in text at notes 123-134 *infra*.

[52] *See also* STAFF OF THE JOINT COMMITTEE ON TAXATION, 94TH CONG., 2D SESS., GENERAL EXPLANATION OF THE TAX REFORM ACT OF 1976, at 568 (Comm. Print 1976), *reprinted in* 1976-3 vol. 2 C.B. 1, 556.

[53] *See* S. 2461, 95th Cong., 2d Sess. (1978). The Treasury supports a modification of the fresh start rules which could exclude nonvoting, nonconvertible preferred stock and perhaps stock subject to a binding buy-sell agreement from the daily proration rules. It is unknown whether the Treasury will adopt the position of S. 2238 that the redemption price of certain preferred stock is its December 31, 1976 value. *See* S. 2238, 95th Cong., 1st Sess. § 2(a)(5) (1977). Nor is it clear what discounts would be allowed for preferred stock in an estate if this view as to December, 1976 values allowing no discount is adopted.

[54] See example in text and note at 44 *supra*.

and a fair market value of $100 at death, if the carryover basis property held by X were subject to depreciation and $30 of depreciation had been taken on a straight-line basis during the period the property was held by X, reducing the date of death adjusted basis to $10, a special calculation must be made in determining the fresh start adjustment. First, the depreciated basis is subtracted from fair market value at death ($100-$10) leaving $90 of appreciation. Next, all depreciation taken ($30) is subtracted from the $90 of appreciation, leaving $60, as if no depreciation had been taken. The $60 figure is then multiplied by the fraction set forth in the example above[55] in which there was no depreciation, and again there results a $40 fresh start adjustment. This adjustment is increased by depreciation attributable to the pre-January 1, 1977 period (in this case, $20 of the total depreciation of $30, since two-thirds of the holding period occurred before January 1, 1977).[56] Finally, the $20 is added to the $40 calculated above to produce a $60 fresh start adjustment. That adjustment is then added to the basis of $10 for purposes of determining gain on a future sale.[57]

When the fresh start adjustment is applicable to depreciable carryover basis property, a problem arises in the calculation of depreciation. Assume facts identical to the example above: a date of death basis of $10 and value of $100 for depreciable property held by X on his death and a $70 basis after the fresh start adjustment. How is depreciation on the property calculated after X's death? Unless present proposals are adopted and the fresh start adjustment applies for purposes of calculating either gain or loss, it will not be clear until the property is sold whether the fresh start adjustment should be made to the basis of the property, since that adjustment is now only applicable in determining gain, not loss. If the property is sold at a loss for $5 the basis in calculating the loss would be $10, not $70.

Section 167(g) provides that for purposes of calculating the section 167(a) depreciation deduction, the basis for determining gain on the sale or other disposition of property is to be used. This rule covers, *inter alia*, the situation where a donee of gift property may have a lower basis for deter-

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[55] *Id.*

[56] If accelerated depreciation had been used, the portion of the $30 of depreciation attributable to years prior to 1977 would presumably be higher with no automatic daily prorating of depreciation, and the fresh start adjustment would be greater. *See* STAFF OF THE JOINT COMMITTEE ON TAXATION, 94TH CONG., 2D SESS., GENERAL EXPLANATION OF THE TAX REFORM ACT OF 1976, at 555 (Comm. Print 1976), *reprinted in* 1976-3 vol. 2 C.B. 1, 567.

[57] *See* I.R.C. §§ 1023(h)(2)(B)(i), (ii). The fresh start adjustment, only applicable to depreciable carryover basis property when the date of death value exceeds the adjusted basis at death, places a premium on making sure that an excess does exist. For example, if the property held by X in the textual example had a basis of $10 and a value of $9 at death, the $20 of pre-1977 depreciation would not be taken into account on a later sale for $30, and there would be $20 of gain, ignoring any additional depreciation. If the date of death value were $11 the gain on a sale for $30 should be eliminated pursuant to § 1023(h)(2)(B) because of the fresh start adjustment for pre-1977 depreciation. It may be that § 1023(h)(2)(B)(i), assuming the value of the property is $11 so that the excess over basis is $1, will cause a reduction in basis. If the $1 excess is reduced by the $30 of depreciation, ($29) might be multiplied by the holding period fraction to determine the portion of the ($29) allocable to the pre-1977 period, and this could reduce the amount of the increase in basis resulting from pre-1977 depreciation. The legislative history suggests that no adjustment is necessary when, after deducting depreciation, the §1023(h)(B)(i) calculation produces a negative number. *See* STAFF OF THE JOINT COMMITTEE ON TAXATION, 94TH CONG., 2D SESS., GENERAL EXPLANATION OF THE TAX REFORM ACT OF 1976, at 558 (Comm. Print 1976), *reprinted in* 1976-3 Vol. 2 C.B. 1, 570.

mining loss than for determining gain under section 1015. Presumably, as a result of section 167(g) the depreciable basis of carryover basis property would be adjusted at the time of death to include a fresh start adjustment.[58]

2. Federal and State Estate Tax Adjustment—Section 1023(c)

(a) Basic Rule and Application

After the fresh start adjustment is made, a second basis adjustment is made under the 1976 Act for federal and state estate taxes[59] which are attributable to net appreciation (represented by federal estate tax value less basis immediately before death as stepped-up by the fresh start adjustment) in carryover basis property subject to those taxes.

(i) *Proposed Modifications.* The determination of how and when the basis adjustments for federal and state estate taxes, as well as the adjustment for state succession taxes, are to be made is a matter currently subject to a great deal of legislative consideration. It is likely that modifications in the carryover basis rules will result in a single adjustment for all federal and state death taxes and that the adjustment will be made after the new higher minimum basis adjustment is made.[60] Assuming that these legislative changes are made, estates which are not required to file estate tax returns may not be required to determine the death tax adjustment. Beginning in 1981, this will include estates the value of whose assets plus all post-1976 taxable gifts does not exceed $175,000. In addition, estates with $175,000 or less of carryover basis assets may not be required to determine the death tax adjustment even if other assets (such as life insurance proceeds) cause the gross estate to exceed $175,000. These estates may, in effect, be al-

[58] This result is questionable. In the § 1015 case of property acquired by gift, § 167(g) allows depreciation to be based on the concept of cost recovery rather than on lower fair market value. Cost recovery in the fresh start area is a nebulous term.

[59] For purposes of this adjustment the term "federal and state estate taxes" means (1) the tax imposed under the federal laws by § 2001 or § 2101 reduced by credits against the tax and (2) any estate, inheritance, legacy or succession taxes for which the estate is liable and which is actually paid by the estate to any state or to the District of Columbia. *See* STAFF OF THE JOINT COMMITTEE ON TAXATION, 94TH CONG., 2D SESS., GENERAL EXPLANATION OF THE TAX REFORM ACT OF 1976, at 557 (Comm. Print 1976), *reprinted in* 1976-3 Vol. 2 C.B. 1, 569. The Joint Committee Explanation indicates that the estate will be treated as liable where it is liable under either local law or the applicable instrument. *Id.* The Joint Committee Explanation further indicates that the additional estate tax imposed on premature dispositions of § 2032A (real) property subject to the special estate tax valuation of § 2032A is not, for these purposes, an estate tax. *Id.*

Frequently, estate taxes are paid by trustees pursuant to the discretionary authority given in a revocable inter vivos trust created by the decedent. It is possible that regulations will specify that such payments will be treated as an estate tax *paid by the estate* (i.e., in satisfaction of its obligation) if the estate is liable under local law or the relevant instrument, even where no probate estate exists because all assets are in the trust or where the assets of the probate estate are insufficient for payments of these death taxes. This matter should, however, be clarified by the regulations to avoid any potential loss of the § 1023(c) adjustment. Until this matter is clarified it might be desirable to have the trustees pay an amount equal to the tax to the executor and let the executor pay the taxes.

[60] *See* S. 2228, 95th Cong., 1st Sess. (1977), and S. 2238, 95th Cong., 1st Sess. (1977), neither of which simplifies the adjustment in basis for death taxes to the extent suggested by the Treasury and incorporated into S. 2461, 95th Cong., 2d Sess. (1978). The Treasury approach discussed in the text simplifies administration of the carryover basis rules.

lowed to step-up the basis of their assets to federal estate tax value because of the higher minimum basis adjustment. Therefore, no death tax basis adjustment would be necessary.

While this change is intended to simplify the carryover basis rules, it will not eliminate the requirement that the executor of an estate determine the basis in the hands of the decedent of all carryover basis assets held by the decedent. Knowledge of the basis will be essential in allocating the minimum basis step-up among appreciated carryover basis assets (those with a federal estate tax value in excess of tax basis after the fresh start adjustment). Further, for carryover basis assets with a tax basis higher than federal estate tax value, it will be the tax basis that will be used in determining gain or loss on a post-death sale.

For estates still subject to the death tax adjustment to carryover basis, under the Treasury proposal and S. 2461,[61] a single death tax adjustment would replace the complicated procedure set forth in the 1976 Act. That adjustment would be calculated with respect to assets or groups of assets by multiplying the excess of federal estate tax value over tax basis at death (after the fresh start and minimum basis adjustments) by the marginal federal estate tax rate (or the next lower rate where less than $50,000 is taxed at the marginal rate). It is likely that this proposal will, because of its administrative advantages, be adopted.

Despite these anticipated legislative changes in the carryover basis rules, the rules under the 1976 Act should be considered. In many respects the "new" rules will undoubtedly parallel the "old" rules. The "old" rules also offer insights into problems which it is hoped the "new" rules, in their final form, will eliminate. Possible legislative changes should be kept in mind while examining the rules under the 1976 Act.

(ii) *The 1976 Act Rules.* Under the 1976 Act the amount of the federal and state estate tax adjustment is added to the basis of carryover basis property to prevent a portion of the appreciation in the property from being made subject to estate and income taxes.[62] Unlike the fresh start adjustment, this adjustment increases the basis of property for purposes of determining both gain and loss on a post-death sale.

Where property is purchased after December 31, 1976 and is therefore not subject to a fresh start adjustment, this second adjustment can be fairly straightforward under the 1976 Act. Assume that X dies in 1981 with an estate of $1,000,000. His assets consist of $900,000 of cash and IBM stock, purchased on January 3, 1977, with a basis of $10,000 and a federal estate tax value of $100,000. All of his assets are distributed to his adult children. Assuming no estate tax deductions, no state death taxes, no credits other than a section 2010 unified credit and no post-1976 adjusted taxable gifts,[63] X's federal estate taxes might be $298,800[64] and the step-up in

[61] S. 2461, 95th Cong., 2d Sess. (1978).
[62] *See* I.R.C. § 1023(c).
[63] *See* I.R.C. § 2001(b).
[64] The estate tax on a $1,000,000 estate is calculated as follows:

Basic tax (§ 2001(c))	= $345,800
Unified credit (§ 2010)	= $47,000
Total tax	= $298,800

basis of the IBM stock under section 1023(c) would be computed as follows:

$$\frac{\$90{,}000 \text{ (federal estate tax value of stock less tax basis immediately before death)}^{65}}{\$1{,}000{,}000 \text{ (federal estate tax value of all property subject to federal estate tax)}} \times \$298{,}800 \text{ (federal estate tax)} = \$26{,}892$$

The adjustment under section 1023(c) would thus be $26,892, increasing the basis of the IBM stock in the hands of the person acquiring it from the decedent to $36,892.[66]

The complexity of the present basis adjustment for federal and state estate taxes is obscured in the example above because the estate has a limited number of assets and it is assumed that the values of the assets in the gross estate are fixed. However, as can be seen from the example, even a slight $1,000 change in the value of any one asset (on audit) in an estate with hundreds of assets would require an adjustment in the section 1023(c) step-up in basis in *each* appreciated carryover basis asset because the denominator of the fraction and the total federal estate taxes would be changed.[67] If a marginal rate approach were used, as the Treasury has suggested, so that all appreciated carryover basis assets received a basis increase based on their net appreciation times the estate's marginal rate (or the next lower marginal rate when less than $50,000 is subject to federal estate tax at the marginal rate) a substantial audit adjustment would be required to place the taxpayer's estate in a different marginal bracket and cause an adjustment in the basis of each appreciated carryover basis asset included in the estate.

[65] $100,000 federal estate tax value minus $10,000 basis immediately before death. Sections 1023(c) and (f)(2) would appear to require each appreciated asset to be viewed separately. *See* STAFF OF THE JOINT COMMITTEE ON TAXATION, 94th CONG., 2d SESS., GENERAL EXPLANATION OF THE TAX REFORM ACT OF 1976, at 557 (Comm. Print 1976), *reprinted in* 1976-3 Vol. 2 C.B. 1, 569 (supporting this reading of the statute). Thus, if the basis of the IBM stock immediately before death was $1,000 and its federal estate tax value was $95,000, the numerator of the fraction would be $94,000 even if the decedent also held Eastman Kodak stock with a basis of $9,000 and a federal estate tax value of $6,000. Of course, if the Eastman Kodak stock did not appreciate, there would be no step-up in basis under § 1023(c) as to it. It is likely that under the 1976 Act a separate § 1023(c) computation would be required with respect to shares of IBM stock purchased at different times and having different bases. Proposed legislation may eliminate this requirement, which is particularly burdensome where, for example, coin or stamp collections are involved. *See* S. 2461, 95th Cong., 2d Sess. (1978).

[66] This example assumes no state estate tax. Problems may result when a state estate tax applies because of the language of the 1976 Act. Section 1023(c) provides that the adjustment for both federal and state estate taxes is made to appreciated carryover basis property subject to federal estate taxes. Further, the denominator of the fraction in making the adjustment is all property subject to federal estate tax. Where the inclusion rules differ for federal and state estate tax purposes, the basis of appreciated property subject to state, but not federal, estate taxes would not be subject to adjustment under § 1023(c). The Technical Corrections Bill amends § 1023(c) to provide that an adjustment be made first for federal estate taxes and added to basis and then a separate adjustment for state estate taxes be computed and added to basis. H.R. 6715, 95th Cong., 1st Sess. § 3(c)(5) (1977). If the Technical Corrections Bill becomes law in its present form this problem will be partly resolved. Alternatively, the legislative proposal for a single adjustment in basis for all death taxes is likely to eliminate this problem.

[67] *See* I.R.C. § 1023(c).

It is likely that this Treasury approach will be adopted and that the step-up in basis of appreciated carryover basis assets for death taxes will be based on a marginal federal estate tax rate, and not on the average federal estate tax rate. It is instructive to note that not all proposals applying a marginal rate approach would, like the Treasury approach, reduce the complexity of the 1976 Act. For example, S. 2228 and S. 2238 would require adjusting the basis of each appreciated carryover basis asset whenever an audit resulted in an adjustment in the net appreciation over basis of any appreciated carryover basis asset.[68]

(b) Modifications

(i) *Encumbrances on Property*. An important consideration in calculating the federal estate taxes applicable to net appreciation in carryover basis property, whether the 1976 Act or the approach of the proposed legislation is followed, is the treatment of liabilities with respect to property. The rules under section 1023 presently differentiate between liabilities with respect to property as to which the estate is liable and those nonrecourse liabilities for which it is not. Any mortgage or other indebtedness with respect to property which is *not* a liability of the estate will reduce the federal estate tax value of the property for purposes of calculating appreciation over basis if the property is included in the gross estate at its unencumbered fair market value.[69] For example, if carryover basis property with a federal estate tax value of $100,000 and a basis of $10,000 were subject to an $80,000 nonrecourse mortgage, the appreciation over basis would only be $10,000 ($100,000 value—$80,000 mortgage—$10,000 basis). This would be the numerator of the section 1023(c) fraction. However, if the mortgage

[68] *See* S. 2228, 95th Cong., 1st Sess. (1977); S. 2238, 95th Cong., 1st Sess. (1977).

[69] I.R.C. § 1023(g)(4). Treas. Reg. § 20.2053-7 (1963) provides that a federal estate tax deduction is allowed for a mortgage or other indebtedness with respect to property that is included in the federal gross estate undiminished by the mortgage. Specifically, the regulation provides that (1) where the estate is liable on the mortgage or other indebtedness, the full value of the property must be included in the gross estate and a deduction is allowed for an amount equal to the mortgage and (2) where the estate is not liable on the mortgage, only the value of the property less the mortgage or indebtedness need be included in the gross estate. It is therefore possible to include in the federal gross estate property subject to indebtedness as to which the estate is not liable either at net value or with an offsetting deduction. In light of those options with respect to property as to which the estate is not liable, § 1023(g)(4) in its present form is not wholly illogical. Perhaps it represents an attempt to assure that for assets subject to indebtedness as to which the estate is not liable, § 1023(c) and § 1023(e) basis adjustments are always determined based on valuation of the property for federal estate tax purposes at its net value (reduced by the indebtedness) whatever election the executor might make. The Joint Committee Explanation seems to confirm this interpretation. STAFF OF THE JOINT COMMITTEE ON TAXATION, 94th CONG., 2d SESS., GENERAL EXPLANATION OF THE TAX REFORM ACT OF 1976, at 558 (Comm. Print 1976), *reprinted in* 1976-3 Vol. 2 C.B. 1, 570.

On the other hand, the House Report accompanying the 1976 Act clearly indicates that the original intent of § 1023(g)(4) was to assure that the § 1023(c) and § 1023(e) adjustments in all property acquired from a decedent be based on the net federal estate tax value of the property, whether or not the estate was liable on the mortgage or other indebtedness. H.R. REP. NO. 94-1380, 94th Cong., 2d Sess. 40-41, *reprinted in* [1976] U.S. CODE CONG. & AD. NEWS 3356, 3395-96. This original goal presumably would be accomplished if § 1023(g)(4)(B) were amended so that it dealt with situations in which the estate was liable on the indebtedness. The regulations could then deal with the election to include in the gross estate at full value property subject to indebtedness as to which the estate was not liable.

in the example above were recourse, that is, if the estate were liable on it, the net appreciation would be $90,000 not $10,000, computed based on the gross value of the property, rather than its net value as reduced by the mortgage. It is not clear why recourse mortgages are treated differently from nonrecourse mortgages under the 1976 Act. In any event, until this rule is modified as it will be by the Technical Corrections Bill[70] it may be desirable, if possible, for elderly individuals to secure nonrecourse loans against property that has not appreciated greatly in value.

(ii) *Property Subject to Estate Tax.* The adjustment to carryover basis property for federal and state estate taxes is limited in that it is only applicable to property subject to tax for federal estate tax purposes.[71] It is likely, given the goal of this adjustment to avoid a doubling up of income and estate tax with respect to the same appreciation in value, that a similar limitation will be applied with respect to any proposal enacted and that S. 2461[72] will be followed in this regard.

As presently enacted, section 1023(f)(4) indicates that for purposes of sections 1023(c) (increasing basis for state and federal estate taxes attributable to appreciation) and 1023(e) (increasing basis for state succession taxes paid by the transferee) appreciated property shall not be treated as subject to federal estate tax to the extent that a marital or charitable estate tax deduction with respect to such property is allowable under sections 2055, 2056 or 2106(a)(2).[73] Thus, if a section 2056 marital deduction is allowable for appreciated carryover basis property bequeathed to a spouse, no federal or state estate tax adjustment under section 1023(c) will be made with respect to the property[74] and the property will not be included in the denominator of the section 1023(c) fraction.

Under present rules highly appreciated carryover basis property transferred to a spouse as part of a marital deduction bequest will not be entitled to an upward adjustment in basis under section 1023(c).[75] There-

[70] The Technical Corrections Bill would allow the unencumbered value of all property, whether or not the estate is liable on the mortgage or indebtedness, to be used in calculating both the numerator and denominator of the § 1023(c) fraction. H.R. 6715, 95th Cong., 1st Sess. § 3(c)(2) (1977). This approach seems to be a reasonable way to effect the purpose of § 1023(c): to allow an increase in basis for taxes paid on appreciation of property. For example, if the IBM stock in the textual example were encumbered with $80,000 of debt, the Technical Corrections Bill would allow the fraction to be determined exactly as it is in the text, treating this debt like any other debt of the estate which does not attach to specific property.

[71] *But see* S. 2228, 95th Cong., 1st Sess. (1977) (allowing the § 1023(c) adjustment to all appreciated property in the estate whether or not it is subject to federal estate tax). This rule, if enacted, would simplify the calculation of the adjustment.

[72] S. 2461, 95th Cong., 2d Sess. (1978).

[73] Because the § 1023(c) adjustment is made only with respect to property subject to federal estate taxes, no § 1023(c) adjustment for state estate taxes would be allowed for property to which a § 2056 deduction applies. While property which qualifies for the § 2057 federal estate tax orphan's deduction is not subject to federal estate tax to any greater extent than marital deduction property, the Joint Committee Explanation indicates that such property, as a matter of administrative convenience, will be deemed subject to federal estate tax for purposes of the § 1023(c) adjustment. STAFF OF THE JOINT COMMITTEE ON TAXATION, 94th CONG., 2d SESS., GENERAL EXPLANATION OF THE TAX REFORM ACT OF 1976, at 558 (Comm. Print 1976), *reprinted in* 1976-3 Vol. 2 C.B. 1, 570. There is no statutory basis for this result unless the exceptions specifically mentioned in § 1023(f)(4) are treated as all-inclusive.

[74] If the property distributed to the spouse is to satisfy a pecuniary bequest, there could be some step-up in basis in any event (and corresponding gain recognition by the estate) by virtue of § 1040.

[75] *See* I.R.C. § 1023(c).

fore, it may be desirable in certain situations to bequeath high basis property with little appreciation to a surviving spouse even though this ultimately might result in higher income taxes if low basis-high value property left after funding the marital trust must be sold to pay death taxes and administration expenses.[76] The low basis-high appreciation property not used to fund the marital trust, of course, would be property subject to federal estate tax and, in many cases, would be subject to a significant step-up in basis, thereby reducing the gain on a later sale. Regulations presumably will state whether an executor or trustee, without jeopardizing the marital deduction, may be given the discretion to fund a maximum marital deduction formula pecuniary bequest with respect to the basis of the assets to be used.[77] The Joint Committee Explanation provides that only property actually used to fund the marital deduction bequest will be deemed not subject to federal estate tax.[78] As yet it is uncertain what the result will be

[76] There are conflicting considerations to take into account in deciding how to fund a marital trust. For example, if a significant portion of the property funding a marital trust is to be sold during the spouse's lifetime to provide for her support, that may be a further reason to fund the marital trust with high basis property with little appreciation so that more funds will be available, after income taxes, to provide for her support. On the other hand, if she is a beneficiary of the residuary trust it may be worthwhile to use low basis-high value property to fund the marital trust and pay significant income taxes on the sale of the marital trust property in order to reduce the amount of her estate which is subject to federal estate taxes. Further, the residuary trust and the ultimate beneficiaries will have less income tax to pay on a later sale if they receive high basis property with little appreciation, and more after-tax dollars may be passed on to subsequent generations. Since it is assumed that the surviving spouse can receive income and principal from the residuary trust at the discretion of the trustees, the reduction of the marital trust by income taxes may not affect her standard of living. These considerations may argue for a different funding than the considerations mentioned in the text. For a discussion of the 1976 Act changes in marital deduction provisions, see in this issue Piper & Fremont-Smith, *Principles for Effective Uses of Marital Deductions*, p. 403 *supra*.

[77] Under prior law the transfer of items of income in respect of a decedent which contained inherent income tax liability to fund a marital trust did not appear to affect the valuation of the property funding the marital deduction. There should be no effect on valuation when the marital trust may be funded with low basis-high appreciation property subject to substantial income tax on a sale, since income tax liability has not had an impact on the estate tax valuation of property in the past and should not under the 1976 Act. Robinson v. Commissioner, TAX CT. REP. ¶ 34,736 (CCH 1977). *Cf.* Rev. Proc. 64-19, 1964-1 C.B. 682. In that procedure the IRS in effect concluded that to obtain a marital deduction (1) where an executor has discretion as to the assets used to fund a marital deduction pecuniary bequest and (2) the bequest is funded based on the estate tax values of the assets, the instrument or applicable state law must provide that the assets chosen are "fairly representative of appreciation and depreciation" of all assets in the estate or that they have an aggregate date of distribution value no less than the amount of the bequest. *Id.* at 683-84. This rule prevents reducing the value of the marital bequest and thus reducing the surviving spouse's estate (at the same time a full marital deduction is taken) by funding the bequest with assets which on the date of distribution have depreciated significantly from federal estate tax values. Applying the same principle in the context of the carryover basis rules could lead to a requirement that property fairly representative of the basis of all property in the estate be used to fund the marital trust. Such a requirement could prevent the funding of the marital trust with low basis property subject to a significant income tax since this approach has the effect of reducing the real value of the marital trust. *Cf.* Treas. Reg. § 1.664-2(a)(4) and 3(a)(4) (1972) (dealing with charitable remainder annuity trusts and unitrusts and requiring that the adjusted basis of property distributed be fairly representative of the basis of property available for distribution).

[78] STAFF OF THE JOINT COMMITTEE ON TAXATION, 94th CONG., 2d SESS., GENERAL EXPLANATION OF THE TAX REFORM ACT OF 1976, at 557-58 (Comm. Print 1976), *reprinted in* 1976-3, Vol. 2 C.B. 1, 569-70.

when all property goes to the spouse. It may be that a certain percentage of each asset will be treated as funding the marital deduction bequest.[79]

When an executor or trustee sells a substantial portion of the property held by him prior to funding either the marital or residuary bequest or trust, it is unclear which assets will receive a step-up in basis due to the section 1023(c) adjustment and which assets are treated as funding the marital bequest or trust. Because of the problems likely to be created, it might be desirable to adopt the solution of two Senate proposals, S. 2228[80] and S. 2238,[81] and simply allow the section 1023(c) adjustment to apply to all appreciated carryover basis property whether or not it is subject to federal estate tax. There would be a much greater section 1023(c) basis adjustment if all appreciated carryover basis property including property funding a marital trust were subject to a section 1023(c) basis step-up based on the marginal federal estate tax rate (or next highest rate) times the net appreciation of the property. This no doubt is why the Treasury continues to maintain the position that property not subject to federal estate tax is not entitled to a section 1023(c) adjustment.[82]

Assuming that property not subject to estate tax does not receive a section 1023(c) basis adjustment, two possible approaches might be used to determine which property is not subject to estate tax where assets are sold, for example, prior to funding a marital trust. One might be to treat the sale of such assets as a sale of nonmarital assets until an amount equal to the residuary bequest or trust has been reached. A second approach might be to develop a formula based on the ratio of the marital bequest or trust to the total estate and treat each sale as a proportionate sale of marital bequest or trust property and of residuary property. Unfortunately, the second approach suffers from the same infirmity as the present section 1023(c) adjustment since it would involve recalculation of the gain on each sale whenever, on audit, the values of the marital and residuary bequests or trusts are changed even slightly.

It will be interesting to see how regulations resolve the immense problems in this area. Perhaps the Treasury, in the name of simplicity, will adopt an approach which excludes from the section 1023(c) adjustment only assets actually distributed to fund a marital or charitable bequest. This simplified approach would put some pressure on executors to sell more assets prior to funding a marital trust than they otherwise might.

(iii) *Interaction With Fresh Start Adjustment.* One final matter that must be considered in connection with the basis adjustment for estate taxes paid is its interaction with the fresh start adjustment. Section 1023(f)(2) makes it clear that the section 1023(c) federal and state estate tax adjustment is determined after the fresh start adjustment is made. For example, if carryover basis marketable stock held by X since 1974 had a basis on December 31, 1976 and at X's death of $100,000, a December 31, 1976 value of $500,000 and a federal estate tax value of $600,000, on X's death in 1981 both a fresh start and federal and state estate tax adjustment would

[79] The House Report of the 1976 Act would suggest this result. H.R. REP. NO. 94-1380, 94th Cong., 2d Sess. 42-43, *reprinted in* [1976] U.S. CODE CONG. & AD. NEWS 3356, 3396-97.

[80] S. 2228, 95th Cong., 1st Sess. (1977).

[81] S. 2238, 95th Cong., 1st Sess. (1977).

[82] S. 2461, 95th Cong., 2d Sess. (1978).

be appropriate. If it is assumed that this is the only asset in X's estate, that the asset is to be distributed to his adult children, that there are no deductions or credits other than the unified credit in calculating X's federal estate tax, and that there is no state death tax, X's federal estate tax would be $145,800, assuming no post-1976 taxable gifts.[83] The fresh start adjustment would raise the basis of the stock to $500,000 (the value of the stock on December 31, 1976),[84] and the section 1023(c) adjustment as it is presently made, would be:

$$\frac{\$100{,}000 \text{ (appreciation in stock after adjusting basis for fresh start adjustment)}^{85}}{\$600{,}000 \text{ (federal estate tax value of X's total estate)}} \times \$145{,}800 \text{ (X's estate tax liability)} = \$24{,}300$$

The $24,300 adjustment is then added to the basis to produce a new adjusted basis of $524,300 for purposes of determining gain on a sale.

What if the stock is eventually sold for $50,000? Can the section 1023(c) federal and state estate tax adjustment be recomputed? If the stock were sold at a loss for $50,000, under present rules no fresh start adjustment would apply, and the basis for purposes of determining the loss would be $100,000 plus the federal and state estate tax adjustment. If the federal estate tax attributable to appreciation could be recomputed so that the numerator of the section 1023(c) fraction were $500,000, that is, the federal estate tax value less adjusted basis without a fresh start adjustment, the basis for purposes of measuring a loss on a sale for $50,000 would be $221,500[86] rather than $124,300.[87]

The 1976 Act does not clearly indicate whether such a recomputation is possible. Unfortunately, both the Technical Corrections Bill[88] and the

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[83] The computation of X's federal estate tax is as follows:

Tax on $500,000	= $155,800
Tax on amount in excess of $500,000 (37% X $100,000)	= $37,000 (§ 2001)
	$192,800
Less unified credit	= $ 47,000 (§ 2010)
	$145,800

[84] See discussion in text at notes 19-25 *supra*.

[85] $600,000 federal estate tax value minus $500,000 basis after fresh start adjustment.

[86] $$\frac{\$500{,}000}{\$600{,}000} \times \$145{,}800 = \$121{,}500 + \$100{,}000 \text{ pre-death basis.}$$

[87] $100,000 pre-death basis plus § 1023(c) adjustment *after* making a hypothetical fresh start adjustment.

[88] *See* H.R. 6715, 95th Cong., 1st Sess. § 3(c)(7) (1977).

temporary treasury regulations[89] referred to above resolve this issue unfavorably to the taxpayer by providing that no recomputation of the federal and state estate tax adjustment, or any other adjustment, can be made simply because carryover basis property subject to a fresh start adjustment is either sold at a loss or for any price below the basis after the fresh start adjustment, producing neither gain nor loss.[90] This rule will not be burdensome if the proposal to have the fresh start adjustment apply both in the determination of gain and loss becomes law.[91]

3. $60,000 Minimum Basis Adjustment—Section 1023(d)

A third adjustment to basis is made if, after the fresh start and the estate taxes paid adjustments are made, the aggregate basis of all the carryover basis property is less than $60,000. This third adjustment provides a formula whereby the basis of each appreciated carryover basis asset, after prior adjustments, is increased to produce a total basis of $60,000 or the federal estate tax value of the appreciated property, whichever is less.[92] This rule, applicable in determining either gain or loss, is presently of marginal significance and will not be discussed further here.

It should be noted, however, that proposals to increase the minimum basis adjustment to $175,000 and to rearrange the order of the adjustments so that the minimum basis adjustment will be made prior to the adjustment for federal and state taxes are presently before Congress.[93] If passed they will have the effect of increasing the importance of this adjustment and, more significantly, of limiting most of the complexities of the carryover basis rules to only those large estates which file federal estate tax returns and have more than $175,000 in carryover basis assets (possibly reduced by insurance, etc.).[94]

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[89] 42 Fed. Reg. 39,104 (1977) (to be codified in Treas. Reg. 7. 1023 (h)-1).

[90] The temporary regulations indicate that this preclusion of any recomputation is the result even if the Technical Corrections Bill does not become law. Temporary Treas. Reg. 7.1023(h)-1(f), Example 1, 42 Fed. Reg. 39,104 (1977) (to be codified in Treas. Reg. 7.1023(h)-1). This may be inconsistent with congressional intent in giving taxpayers the benefits of prior law through December 31, 1976 by enacting the fresh start adjustment.

[91] *See, e.g.*, S. 2461, 95th Cong., 2d Sess. (1978).

[92] The calculation of the § 1023(d) basis adjustment with respect to any appreciated property will be subject to readjustment if an IRS audit results in a change in the value of any appreciated property. This is because the basis adjustment is allocated to each appreciated carryover basis asset based on the net appreciation in that asset compared to the net appreciation in all appreciated carryover basis assets. This approach will create problems similar to those discussed with respect to § 1023(c). Further, it will become far more significant if the minimum basis adjustment is increased from $60,000 to $175,000 and applied to adjust basis prior to the application of the § 1023(c) estate tax adjustment.

[93] *See* S. 2228, 95th Cong., 1st Sess. (1977); S. 2461, 95th Cong., 2d Sess. (1978). The Treasury supports this change with certain modifications. *See* Statement of Donald C. Lubick, *supra* note 42, at J-6.

[94] In October of 1977, the Treasury was strongly opposed to a $175,000 minimum basis rule that does not take into account non-carryover basis assets such as insurance. Under the Treasury's approach the amount of the minimum basis adjustment would be reduced from $175,000 to some lower number by insurance, to avoid allowing someone with a $1,000,000 estate, $825,000 of which is insurance, from obtaining the benefits of a minimum basis rule intended to apply generally to small estates which do not file estate tax returns.

4. State Succession Tax Paid by Transferee Adjustment—Section 1023(e)

After the adjustments discussed above have been made, the basis of carryover basis property may be further increased, pursuant to section 1023(e), by the portion of any state succession tax which was paid by the person who acquired the property from the decedent and which was attributable to the net appreciation in value of the property. For purposes of section 1023(e), net appreciation is the difference between the federal estate tax value of the property and its basis immediately prior to death (after prior section 1023 adjustments).[95]

Taxes which qualify for this adjustment are estate, inheritance, legacy or succession taxes paid to a state or the District of Columbia by the recipient of the property with respect to which the estate of the decedent is not liable.[96] Like the section 1023(c) adjustment which will be applicable only when property is actually subject to federal or state estate taxes, property not subject to state succession taxes will not be subject to any section 1023(e) adjustment.[97] The fraction used in determining the section 1023(e) adjustment, like the section 1023(c) fraction, is:

$$\frac{\text{Federal estate tax value}^{98}\text{ less basis of asset passing to transferee (after prior section 1023 adjustments)}}{\text{Federal estate tax value of all property acquired from the decedent by the transferee and subject to state succession taxes}} \times \text{state succession taxes paid}$$

Complications may result in states which provide that the inheritance taxes on future interests in property are to be determined based on the actual beneficiaries and, unless settled at some earlier time, paid when the interests are no longer future interests. There is some question as to when and how the appropriate adjustment will be made in such a case, particularly if the property is sold before the future interests mature. Because of these and other complications with respect to the section 1023(e) adjustment, it is likely that this adjustment will be eliminated and replaced by the single marginal rate adjustment previously discussed.[99] One problem which

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[95] *See* I.R.C. § 1023(f)(2).

[96] The Technical Corrections Bill, recognizing that the estate sometimes is technically liable under state law for state succession taxes actually paid by an heir, would remove the requirement for a § 1023(e) adjustment that the estate must not be liable. *See* H.R. 6715, 95th Cong., 1st Sess. § 3(c)(6) (1977). Nevertheless, the adjustment still is limited to taxes actually paid by the person acquiring the property from the decedent.

[97] The Joint Committee Explanation indicates that the basis of property not subject to state succession tax because of an orphan's deduction similar to § 2057 will not be adjusted pursuant to § 1023(e). STAFF OF THE JOINT COMMITTEE ON TAXATION, 94th CONG., 2d SESS., GENERAL EXPLANATION OF THE TAX REFORM ACT OF 1976, at 558 (Comm. Print 1976), *reprinted in* 1976-3 Vol. 2 C.B. 1, 576. *Compare* § 1023(f)(4)(B) *with* § 1023(f)(4)(A).

[98] Notably the values used are federal estate tax values even though the taxes concerned are state taxes. It is uncertain whether the calculation of state succession taxes will be made separately for each state when the rules of inclusion differ by state.

[99] See text and note 61 *supra*.

the single marginal rate adjustment might take into account is the fact that the rules regarding property subject to death taxes may differ for federal and state tax purposes and that a state death tax may apply when a federal estate tax does not.

C. *Miscellaneous*

In addition to the basic rules and adjustments discussed above, there are a number of miscellaneous rules under section 1023 and related sections that were included in the 1976 Act. These rules will be discussed briefly.

1. Unknown Basis—Section 1023(g)(3)

In some cases it will be extremely difficult or impossible to determine the basis of property owned by a decedent both for purposes of section 1023 adjustments and for determining future gain or loss. Section 1023(g)(3) provides that where the facts necessary to determine the basis of carryover basis property are unknown to the person acquiring the property from the decedent, it can be presumed that the basis equalled the fair market value of the property on the date it was purchased by the decedent or last purchaser. However, this rule may not be helpful when, for example, property has been given to the decedent by a prior holder or when the purchase dates of items in a collection must be determined, since it may be as difficult to determine the dates of purchase as it is to determine the basis.[100]

2. Reporting Requirements—Sections 6039A, 6694

The 1976 Act requires the executors of the estates of decedents dying after December 31, 1976 to provide the Secretary of the Treasury with certain information regarding carryover basis property.[101] Further, each person who acquires carryover basis property from a decedent must be furnished by the executor with information as to its tax basis.[102] Pursuant to section 6694, failure to furnish the relevant information in a timely fashion may subject the executor to penalties of up to $7,500 unless the failure can

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[100] See § 3(c)(1) of the Technical Corrections Bill which attempts to deal with this problem in determining the fresh start basis for tangible personalty. H.R. 6715, 95th Cong., 1st Sess. § 3(c)(1) (1977). Proposals have been made to extend the § 3(c)(1) treatment to all carryover basis property other than marketable bonds and securities. One such proposal, S. 2461, is discussed in various sections of the text.

[101] *See* I.R.C. § 6039A. *See* 43 Fed. Reg. 16,734-35 (1978) (to be codified in Temporary Treas. Reg. § 7.6039A-1) which sets forth the requirements for the information to be filed with the Internal Revenue Service and recipients of carryover basis property, the forms to be used, and the time for filing. Because these rules are new, all executors are given until October 31, 1978 to file the appropriate information even if October 31, 1978 is more than nine months subsequent to the decedent's death.

[102] Presumably, the executor will not be required to determine any § 1023(e) basis adjustment. Such adjustments should be known and made by the beneficiary receiving the property. H.R. REP. No. 94-1380, 94th Cong., 2d Sess. 46 (1976). *See* 43 Fed. Reg. 16,734-35 (1978) (to be codified in Temporary Treas. Reg. § 7.6039A-1) supporting this approach.

be excused because it is due to reasonable cause.[103] In this regard an executor should realize that his reporting obligations under section 6039A may cover not only property in the probate estate but also property passing by joint ownership, through trusts and the like.[104] It is likely that executors will, where possible, require protection from the section 6694 liability by various indemnification clauses in wills and trusts. In effect the executor would demand that the will or trust instrument include a clause requiring the estate to indemnify him, effectively releasing him from liability for late or insufficient filing. Assuming such indemnification is permissible under applicable law, it could be the estate, and not the executors, that ultimately will bear any section 6694 liability.[105] Since one of the incentives for accurate and timely filing would be removed by such indemnification, it is questionable whether such indemnification is consistent with the intent of section 6694.

3. Amendment to Section 1015(d)

Amendments to section 1015(d) included in the 1976 Act reduce the amount by which the basis of gift property may be increased. Prior to the effective date of the amendments gift property had a basis in the hands of the donee equal to its basis in the hands of the donor plus any federal—but not state—gift taxes paid with respect to the gift property, although this basis could not exceed the fair value of the property. Section 1023 provides that, for gifts made after December 31, 1976, the basis shall be increased only by the amount of federal gift taxes paid with respect to the appreciation inherent in the gift property at the time of the gift.[106] The basis continues to be limited to fair value. It is likely that when and if the

[103] *See* STAFF OF THE JOINT COMMITTEE ON TAXATION, 94th CONG., 2d SESS., GENERAL EXPLANATION OF THE TAX REFORM ACT OF 1976, at 563 (Comm. Print 1976), *reprinted in* 1976-3 Vol. 2 C.B. 1, 575.

[104] Where there is no executor, the person acquiring the property from the decedent assumes the executor's obligation of reporting to the Secretary of the Treasury. *See* I.R.C. § 2203. This requirement is likely to be ignored by many recipients of property from very small estates. Further proposals which would increase the minimum basis adjustment to $175,000 may reduce the reporting requirements. These proposals do not appear to cover cases in which the federal estate tax value of property is $175,000 or less but the tax basis is much higher (e.g. $250,000). In such cases it will be important that both the Treasury and the recipients of property know the carryover basis for purposes of calculating gain or loss on a future sale.

[105] *See* 43 Fed. Reg. 16,734-35 (1978) (to be codified in Temporary Treas. Reg. § 7-6039A-1) indicating that the deadline for furnishing carryover basis information to distributees of an estate will be no earlier than six months after the due date of the federal estate tax return. The appropriate information must be filed with the IRS by the time the estate tax return is filed.

[106] Section 1015 does not provide a basis adjustment for state gift taxes similar to the adjustments under § 1023 for state death taxes, although present legislative proposals would change this result. There is also no credit against federal gift taxes for state gift taxes. *Compare* § 2011 (providing a credit for state death taxes) with § 2012 (providing a credit only for federal gift taxes). In some cases where state transfer taxes are significant and property is not expected to appreciate in value, these rules may make it desirable to hold property until death. *See* § 691(c), modified by the 1976 Act so that federal and state estate taxes, as defined for purposes of § 1023(c), at an average rather than marginal rate are taken into account in determining the income tax deduction resulting from subjecting income in respect of a decedent to death taxes. Proposals are likely to be adopted modifying the § 691(c) deduction so that it is again determined on a marginal rate basis.

section 1023(a) adjustment is modified so that it is based on marginal federal estate tax rates, the gift tax adjustment under section 1015(d) will be similarly changed.

4. Use of Appreciated Carryover Basis Property to Satisfy Pecuniary Bequest—Section 1040

As Revenue Ruling 66-207[107] indicates, under pre-1976 Act law the distribution of property by an estate or trust to satisfy a dollar amount bequest was treated as a sale of the property resulting in gain or loss[108] to the estate or trust and a fair market value (cost) basis to the beneficiary-recipient. Prior to the effective date of the 1976 Act, these taxable distributions usually did not result in significant gains or losses to the estate or trust because of the step-up or step-down in basis to federal estate tax value at death. Thus, only appreciation or depreciation occurring subsequent to death (or the elected alternate valuation date) would be recognized when property was distributed to satisfy a pecuniary bequest.

The carryover basis rules of section 1023, standing alone, would have made it far more likely that distributions of property to satisfy pecuniary bequests would produce significant income tax consequences, even after the carryover basis adjustments. Since the distribution is regarded as a taxable event the estate would realize income upon distribution in the amount of the appreciation over basis. This income tax exposure would have been particularly troublesome where marital deduction bequests structured as formula pecuniary bequests (that is, for specific dollar amounts) which insure a maximum marital deduction[109] in the decedent's estate were satisfied with assets with a value far in excess of their adjusted carryover basis.[110]

New section 1040 is intended to deal with this problem. Under this section the gain recognized on the satisfaction of a pecuniary bequest with appreciated carryover basis property (property whose federal estate tax value exceeds its basis immediately before the decedent's death) is limited to the excess of the value of the property at the time of distribution over its federal estate tax value.[111] In effect, the pre-1976 Act rules are continued to some extent.[112] Section 1040 will apply when the bequest is satisfied by

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[107] Rev. Rul. 66-207, 1966-2 C.B. 243. *See* Rev. Rul. 60-87, 1960-1 C.B. 286. If property held on December 31, 1976 by an estate or trust is used to satisfy a dollar amount bequest, any fresh start adjustment would be lost because the basis of the property in the hands of the recipient would not reflect the basis of the property on December 31, 1976.

[108] *But see* I.R.C. § 267 disallowing loss deductions on distributions from a trust.

[109] *See* I.R.C. § 2056.

[110] A fractional share formula, giving the surviving spouse a fractional share of each asset in the estate and also producing a maximum marital deduction, will not create income tax problems although it may create administrative problems. The distribution of property in satisfaction of a fractional share bequest will not be a taxable event. *See* Rev. Rul. 55-117, 1955-1 C. B. 233.

[111] I.R.C. § 1040(a). It would appear that depreciation recapture rules, particularly § 1245 and § 1250, override § 1040 and result in additional recognition of income. This seems clearly inconsistent with the goal of § 1040: limiting the income tax recognition on the distribution of property to satisfy pecuniary bequests to what it would have been under pre-1976 Act law. Legislative proposals have been made to clear up this technical problem and to limit recapture gain to the gain recognized under § 1040. *See* S. 2461, 95th Cong., 2d Sess. (1978).

[112] For purposes of determining a loss, § 1040 does not apply. If property used by an estate to satisfy a pecuniary bequest had a value far below its carryover basis, a substantial loss might be recognized, assuming the property is distributed at date of distribution values to

the executor of the estate and, to the extent provided in regulations, when a person by reason of the decedent's death has the right to receive a dollar amount bequest (which is the equivalent of a pecuniary bequest) from a trust and the trustee satisfies the bequest with carryover basis property.[113] As a corollary to the limited recognition of gain under section 1040, section 1040(c) provides that the basis of the property received by the recipient of a pecuniary bequest subject to section 1040(a) or (b) is limited to its basis prior to distribution increased by the gain recognized by the estate or trust.

A pecuniary formula marital deduction bequest may be funded by distributing property at date of distribution values or at federal estate tax values. Where date of distribution values of appreciated property are used to satisfy a pecuniary bequest, section 1040 limits the gain to the estate to the gain under pre-1976 Act law.[114]

One of the technical problems related to new section 1040 concerns situations in which property is distributed at federal estate tax values to satisfy a pecuniary marital deduction bequest. Revenue Procedure 64-19[115] requires in order for the marital deduction to be allowed—when federal estate tax values, as opposed to date of distribution values, are used to determine the property used to satisfy a marital deduction pecuniary bequest—that property "fairly representative of appreciation and depreciation in the value of all property" or property with a date of distribution value no less than the amount of the bequest be distributed to satisfy the bequest. Under pre-1976 Act law, where the bequest was satisfied with property valued at federal estate tax values, no gain or loss was recognized to the estate since the basis of the property (federal estate tax value) would equal the distribution value as valued to satisfy the bequest. Under the 1976 Act, however, gain may be recognized when property that has appreciated over its federal estate tax value is used to satisfy a pecuniary bequest at federal estate tax values. Unless regulations provide otherwise, when the federal estate tax value equals the amount of the bequest under a "fairly representative" formula and the property used to satisfy the bequest has appreciated above its federal estate tax value, arguably, gain will be recognized under section 1040 even though the appreciation is not used to satisfy the bequest.[116] Presumably, the gain would be limited not only by

satisfy the pecuniary bequest. If the value of the property were below the federal estate tax value but above basis at the time of distribution, no gain or loss would be recognized because of § 1040.

[113] I.R.C. § 1040(b). It is uncertain how § 2032A property (farm and certain other qualified real property) will be valued for purposes of determining federal estate tax value under § 1040. If it is valued under the special reduced valuation procedures of § 2032A, as opposed to a § 2031 or § 2032 valuation, a greater gain will result on its distribution to satisfy a pecuniary bequest (the difference between date of distribution value and the § 2032A federal estate tax value) than would result if § 2032A did not apply for purposes of § 1040. This would defeat, in part, the tax relief provided by § 2032A. The Technical Corrections Bill proposes to limit the gain under § 1040 as if § 2032A did not apply in determining federal estate tax value. *See* H.R. 6715, 95th Cong., 1st Sess. § 3(d)(3) (1977).

[114] *See* I.R.C. § 1040(a).

[115] Rev. Proc. 64-19, 1964-1 C.B. 682.

[116] The Joint Committee Explanation indicates that the intent of § 1040 was to limit gain to the gain under prior law. STAFF OF THE JOINT COMMITTEE ON TAXATION, 94TH CONG., 2d SESS., GENERAL EXPLANATION OF THE TAX REFORM ACT OF 1976, at 562-63 (Comm. Print 1976), *reprinted in* 1976-3 Vol. 2 C.B. 1, 574-75. Thus, the regulations might provide that no gain is recognized when "fairly representative" property is distributed at federal estate tax values to satisfy a marital deduction pecuniary bequest since it is the federal estate tax value

appreciation over federal estate tax value by means of section 1040, but also by the pecuniary bequest satisfied. Thus, if property with a federal estate tax value of $500,000, a date of distribution value of $600,000 and a basis of $450,000 is used to satisfy a $500,000 bequest, the gain should be $50,000, not $100,000.

III. PLANNING PROBLEMS AND OPPORTUNITIES

The technical rules under section 1023, both as presently enacted[117] and as they will presumably be modified, create various planning problems and offer new planning opportunities for the tax practitioner. The tax consequences of various transactions have changed, leading to changes in many of the ground rules of estate planning. This article will now consider some of the areas affected by section 1023.

A. *Flower Bonds; Automatic Long-Term Capital Gains*

Certain special series of treasury bonds can still be purchased shortly prior to death at a substantial discount from face value because of their low interest rate.[118] On death these so-called "flower bonds" can be redeemed at face value to the extent that they are properly used to satisfy the federal estate tax liability of the purchaser.[119] For example, if death follows the purchase of the bonds by three months, a purchase at a 20% discount will return 25% in a three month period. While the bonds were included in the gross estate at face value to the extent used to pay estate taxes, there was no federal income tax under pre-1976 Act law on their redemption at face value because of the step-up in income tax basis to federal estate tax value at death.

Under the carryover basis rules the appreciation in the bonds over their carryover basis will be subject to an income tax on their redemption. While the income tax gain on these capital assets might be treated as a short-term capital gain because the bonds were held for less than the required period for long-term gain treatment under section 1222(3), an executor, with careful planning, should be able to assure long-term capital gain treatment on redemption.

Section 1223(11) provides that capital assets acquired from a decedent and having a section 1014 federal estate tax value basis will be automatically treated as held by the person acquiring them on death for the period necessary for long-term capital gain treatment. Yet, until the Technical Corrections Bill becomes law,[120] this section will not apply where assets receive a carryover basis at death. Unlike prior law, however, under section 1223(2) the holding period for carryover basis property acquired from a decedent will include the period during which the decedent held the property. For most carryover basis capital assets, this should result in a holding

alone which actually satisfies the bequest. As under prior law, the appreciation would go unrecognized under this approach until the property is sold by the distributee.

[117] I.R.C. § 1023.

[118] *See generally* FED. EST. & GIFT TAX REP. ¶ 9,764.075-78 (CCH 1977).

[119] A purchase by a revocable trust may be treated as a purchase by the decedent for these purposes.

[120] *See* Technical Corrections Bill, H.R. 6715, 95th Cong., 1st Sess. § 3(c)(4) (1977) (providing automatic long-term status for carryover basis property).

period long enough so that a sale or exchange will be subject to the special income tax treatment still available for long-term capital gains. But for flower bonds bought shortly before death, tacking on the decedent's holding period may not, in 1978 and subsequent years, cause the holding period to exceed one year at the time the bonds are redeemed unless the taxpayer obtains an extension[121] of the time for paying the tax and redeeming the bonds.

If there is a long-term capital gain on the redemption of these bonds, the additional minimum tax on tax preference items must also be considered.[122] Even if long-term capital gain benefits can be obtained on a redemption, the tax benefits of flower bonds have been significantly reduced as a result of the 1976 Act.

B. *Section 303 Redemption–Section 306 Stock*

The impact of the carryover basis rules on section 303 redemptions is, in many respects, similar to its impact on flower bonds. Under section 303 the proceeds of a qualifying redemption of stock of the decedent used to pay death taxes and administration expenses will be taxed at capital gains rates, even though a similar distribution would be treated as a dividend and the entire amount, not just the excess over basis, would be taxed at ordinary income rates if the stock were redeemed by the decedent during his lifetime.[123] Coupled with the rules under section 1014, stepping-up basis to federal estate tax value, a section 303 stock redemption generally resulted in little or no income tax exposure under prior law.

The carryover basis rules have changed this income tax result. Any section 303 redemption will now be subject to capital gains taxes on any appreciation over the stock's original basis as adjusted under section 1023. The proceeds of the sale will therefore go to pay not only administration expenses and death taxes, but the income tax incurred on redemption as well. Further, additional redemptions cannot be made under section 303, free of dividend treatment, to cover this income tax cost of section 303 redemptions of carryover basis stock.[124] Thus, because of this increased income tax exposure, a section 303 redemption may not solve the liquidity problems of an estate as it did under pre-1976 Act law. Since the purpose of section 303 is to reduce the liquidity problems of estates whose principal asset is stock in a closely-held corporation, this result is unfortunate. In many cases the liquidity problems will, however, be solved by extending the term of payment of estate taxes over ten to fifteen years.[125]

Where section 306 stock[126] is redeemed in what would otherwise qualify as a section 303 redemption, the impact of the carryover basis rules may

[121] An extension may be obtained under § 6161 or otherwise.

[122] *See* I.R.C. §§ 56-58. One half of the long-term capital gain would constitute a tax preference item. I.R.C. § 57(a)(9). This article will not discuss the § 691 income in respect of a decedent implications of flower bonds.

[123] *See* I.R.C. § 303.

[124] Proposed legislation would allow additional redemptions to cover a portion of the income tax cost of the § 303 redemption. *See* S. 2228, 95th Cong., 1st Sess. (1977). The Treasury opposes this expansion of § 303. *See* Statement of Donald C. Lubick, *supra* note 42, at J-8.

[125] *See* I.R.C. §§ 6161, 6166, 6166A.

[126] See § 306(c) for the definition of § 306 stock. Preferred stock issued in a recapitalization of a family business will often be § 306 stock since the distribution of preferred stock will usually be substantially equivalent to a stock dividend. If stock is classified as § 306 stock, on

be disastrous. Under pre-1976 Act law, death had the effect of converting section 306 stock into stock which was not 306 stock in the hands of a person acquiring it from the decedent.[127] This was because section 306 stock acquired a new basis equal to its federal estate tax value on death, and therefore its basis in the hands of the person acquiring it from the decedent was not determined by reference to its basis as section 306 stock.[128] Because section 306 stock lost its taint at death it was subject to the special redemption rules of section 303 like any other stock. Under the 1976 Act, as a result of the carryover basis rules, the section 306 taint will not be removed by death since the stock's basis in the hands of the person acquiring it from the decedent will be determined by reference to the decedent's basis as it is in the gift context.[129]

Section 303 provides only that, where applicable, a redemption will be treated as a distribution in full payment in exchange for stock. The exchange language is intended to prevent section 301 dividend treatment with respect to the redemption of stock under section 303. However, under section 306, amounts realized on "the exchange" of section 306 stock are subject to ordinary income treatment.[130] Thus, when, under the 1976 Act, section 306 stock is redeemed pursuant to section 303, the amount received "in exchange for" the stock under section 303 could technically be subject to dividend treatment pursuant to the statutory rules of section 306.[131]

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its sale or redemption the entire proceeds received are subject to ordinary income treatment, unless one of a number of exceptions applies. This treatment is to be distinguished from a sale of non-§ 306 stock which may be, with minor exceptions (such as § 341), subject to long-term capital gains treatment on any gain realized. *See* Lowe, *"Bailouts: Their Role in Corporate Planning"*, 30 TAX L. REV. 357 (1975).

[127] *See* Int. Rev. Code of 1954, c. 1 § 306(c)(1)(C), 68A Stat. 92 (now I.R.C. § 306(c)(1)(C)); *see also* Treas. Reg. § 1.306-3(e) (1973).

[128] I.R.C. § 306(c)(1)(C).

[129] *Id.*

[130] I.R.C. § 306(a)(1). It is assumed that adequate earnings existed at the time of the distribution of the § 306 stock and on its redemption so that there is no question but that the stock is § 306 stock and that the amount received in redemption might be treated as ordinary income under § 306. *See* I.R.C. § 306(c)(2), (a). *But see* Treas. Reg. § 1.303-2(d) (1975) (indicating that § 306 stock issued in a post-death recapitalization may be subject to the benefits of § 303(a)).

[131] There are some exceptions to dividend treatment for a redemption or exchange of § 306 stock. The most common exception is when the taxpayer has terminated his entire stock interest in the corporation at the time of the § 306 redemption. *See* I.R.C. § 306(b)(1). Because of § 318 attribution this exception is unlikely to apply to the typical closely-held business in which the older generation's § 306 preferred stock is redeemed at death from estates or trusts and the younger generation continues to hold the common stock of the corporation. *See* I.R.C. §§ 306(b)(1), 302(b)(3). Under certain circumstances outlined in § 302(c)(2) the attribution rules of § 318(a)(1) may be waived. However, the IRS has taken the position that the estate or trust of a decedent redeeming all of its stock interest in a closely-held corporation pursuant to § 302(b)(3) cannot waive family § 318(a)(1) attribution, pursuant to § 302(c)(2), in determining whether or not a complete termination under § 302(b)(3) has occurred. *See* Rev. Rul. 68-388, 1968-2 C.B. 122; Rev. Rul. 59-233, 1959-2 C.B. 106. The courts have rejected the IRS view that only an individual can waive § 318(a)(1) attribution under § 302(c)(2). Crawford v. Commissioner, 59 T.C. 830 (1973), *nonacq.* 1974-2 C.B. 5 (estate can waive attribution). In any event, since attribution to an estate or trust of a decedent typically is, pursuant to § 318(a)(3), from beneficiaries or heirs who are younger generation shareholders, and since this attribution cannot be waived under § 302(c)(2), § 302(b)(3) is unlikely to be helpful in many cases even if *Crawford* is followed.

When the Technical Corrections Bill becomes law, however, the problems created by the potentially disastrous interaction of sections 303 and 306 should be eliminated.[132] That bill attempts to clarify the impact of the interaction between the two sections[133] by modifying section 306 to make it clear that section 303 special treatment applies to a redemption of section 306 stock. Under the Technical Corrections Bill a redemption of section 306 stock pursuant to section 303 would result in capital gains treatment on the excess of the proceeds over the stock's basis just as if stock which is not section 306 stock is being redeemed. Until the bill becomes law or regulations which incorporate the provisions of the bill are passed, however, the careful practitioner should assume that section 303 treatment does not apply to section 306 stock even though this adverse treatment of section 306 stock is clearly inequitable. For example, if a shareholder owning 100% of the common stock of a corporation died, his estate could redeem his common stock at capital gain rates under section 303. The estate's ownership of the corporation would still be 100%. Thus, a "bailout" of earnings at capital gains rates is achieved. If instead the shareholder held common stock and section 306 preferred stock and the preferred stock were redeemed, the redemption could be treated as a dividend, assuming adequate earnings. Again the estate would retain 100% ownership after the redemption yet under these circumstances the redemption would result in a dividend taxable in full at ordinary income rates rather than a sale taxable at capital gains rates to the extent the proceeds exceed the stock's basis.[134]

C. *Lifetime Gifts*

It is a misconception to believe that the carryover basis rules of section 1023 have eliminated the concepts of step-up and step-down in basis from the tax lexicon. For example, when a gift of carryover basis stock purchased after 1976 with a high basis ($100) and low value ($10) is made by a father to his son, a later sale by the son for $60 will not result in any recognized loss. Section 1015(a) provides that where the basis of gift property is higher than its then-fair market value on the date of the gift, the basis will be stepped-down to the fair market value for purposes of determining the loss on any sale by the donee.[135] If, however, the father had held the

[132] *See* Technical Corrections Bill, H.R. 6715, 95th Cong., 1st Sess. § 3(a)(2) (1977). Even if the Technical Corrections Bill does not become law, it is likely that regulations will eliminate the problems in this area and indicate that § 306 stock can be redeemed in a § 303 redemption with the same tax consequences as a § 303 redemption of non-§ 306 stock.

[133] *Id.*

[134] The Technical Corrections Bill, recognizing the problems created with respect to § 306 stock, would add a new section to § 306 which would provide that the amount treated as ordinary income, presumably on a sale or a § 302(b)(1) or (2) redemption of § 306 stock which is carryover basis property in the hands of the recipient and which is issued prior to January 1, 1977 shall not exceed the excess of the amount realized over the stock's adjusted basis on December 31, 1976 as increased by the fresh start adjustment. H.R. 6715, 95th Cong., 1st Sess. § 3(a) (1977). This amendment, if enacted, would at least reduce the inequities in this area.

[135] The son's holding period for the stock would still include the father's under § 1223(2). If for purposes of determining gain *or* loss the son's basis is, in whole or in part, the same as the father's, then the father's holding period will be tacked on.

stock until his death and bequeathed it to his son who then sold it for $60, assuming no section 1023 adjustments, a $40 loss ($100 basis—$60 sales price) would be recognized because of the carryover basis rules of section 1023(a). The difference in treatment between a transaction covered by sections 1023 and 1015 makes it advisable in making gifts to select, if possible, property other than property which, if sold, would produce a significant tax loss since this loss cannot be recognized in a sale by the donee. Often, the taxpayer-donor may decide to sell this loss property, recognize the loss and give away the cash proceeds.

Additionally, where a fresh start adjustment is applicable, it may often be desirable for an older taxpayer to select carryover basis property other than low basis-high value property in making gifts to the younger generation. Because the fresh start adjustment for property other than marketable bonds or securities depends on the portion of the total holding period to the date of death represented by the pre-1977 period, property that has been held for a number of years prior to 1977 might receive a substantial fresh start step-up in basis (reducing gain on a future sale) if it is held until death. However, if the property is given to a child who holds it until death, his fresh start adjustment, assuming he dies some thirty or forty years after his father, would be substantially less because a greater portion of the holding period would be post-1976.

In summary, given the choice between giving away carryover basis property—which is not a marketable bond or security—purchased in 1965 with a (1) value of $1,000 and basis of $10, (2) value of $1,000 and basis of $10,000 or (3) value of $1,000 and basis of $1,000, it would be preferable taxwise to give away the property with a $1,000 basis, other factors being equal.

D. *Aging Assets*

The fresh start adjustment for property other than a marketable bond or security puts a premium on having as much of the holding period of an asset as possible antedate January 1, 1977 and as little as possible come thereafter. It has been suggested that a special technique may be available to increase the pre-1977 portion of the holding period. As an example of this technique, assume that land, purchased on January 1, 1975 by the taxpayer, is transferred as a contribution to the capital of a closely-held corporation which was organized on January 1, 1967. Assume also that the corporation has always been 100% owned by the taxpayer. This transaction may have increased the land's pre-1977 holding period because of the property's absorption by the corporation. In valuing the taxpayer's estate the stock of the corporation will be valued based on the assets of the corporation, including the land. The land would not be valued separately.

If this approach should work, for purposes of the fresh start adjustment the basis of all of the stock will be adjusted based on a holding period beginning on January 1, 1967 and ending on the date of the taxpayer's death. The effect of "aging" the holding period of the land is substantial. For example, assume that the stock had a basis of $10 and a value of $100 (without taking into account the real estate) on the taxpayer's death on December 31, 1986, and that the real estate had a basis of $500 and a value of $5,000 on the date of death. If each asset received a separate step-up in basis for the fresh start adjustment, the basis of the stock would be stepped-up to $55[136] and the basis of the land to $1,250.[137] If the land were contributed to the corporation and if the stock's holding period were not affected, in whole or in part, by the contribution, the basis of the stock would be stepped-up from $510[138] to $2,805.[139] Assuming this technique works, the fresh start adjustment from contributing the realty to the corporation would be increased by $1,500.

It is unlikely, however, that this technique will be successful. It should be noted that if the real estate were purchased after 1976, it might also be contributed to the capital of the corporation to obtain a fresh start adjustment. Yet to allow such an adjustment for property acquired after 1976, would fly in the face of section 1023. The regulations are likely in all cases to treat a portion of the old stock as newly issued in exchange for the property contributed, based on a comparison between the value of the property contributed and the value of other property of the corporation.[140] For the venturesome, this technique might be used in cases which are not flagrant—for example, the scheme will clearly be attacked when property purchased in 1977 or later is contributed to the corporation. While there may be nothing to lose in trying this technique, to avoid any surprises it may be desirable to wait until regulations are issued in this area.[141]

E. *Contemplation of Death Sales*

Under prior law it was generally desirable to hold appreciated property until death. As a result of the step-up in basis to federal estate tax value at death, a sale immediately subsequent to death did not result in any federal income tax gain, while on a sale immediately prior to death the gain equalled the unrealized appreciation in the property.

The carryover basis rules of section 1023 as presently enacted may reverse this prior rule of thumb. Assuming appreciated property not subject to a fresh start adjustment is to be sold immediately prior to or after death, it may often cost less federal income and estate tax dollars (ignoring state taxes) to sell the property prior to death.[142] The tax savings of a pre-death

[136] For convenience, the ratios have been based on the number of years, not days, prior to January 1, 1977. ($100 - $10) x 10/20 = $45 fresh start adjustment.

[137] ($5,000 - $500) x 2/12 = $750 fresh start adjustment.

[138] $10 + $500 basis in the real estate. *See* I.R.C. § 362(a)(2).

[139] ($5,100 - $510) x 10/20 = $2,295 fresh start adjustment.

[140] The regulation's position could be based on an analogy to substantial improvements as separate property. *See* I.R.C. § 1023(h)(2)(D). *See also* S. 2228, 95th Cong., 1st Sess. (1977) (modifying the definition of "substantial improvements" to cover transfers to corporations, partnerships or trusts).

[141] There are several issues, such as collapsible corporation questions, which should be examined carefully before it is determined to use this technique. It is likely that nothing will be gained from the use of this technique.

[142] Because under the 1976 Act the denominator of the § 1023(c) and § 1023(e) fraction would be reduced by debts paid immediately before, but not immediately after, death and because reducing the denominator increases the § 1023(c) and (e) adjustments, an additional kind of contemplation of death planning not discussed in the text may also be advisable with regard to payment of debts.

sale result from the fact that the federal income taxes paid on a pre-death sale will reduce the assets subject to estate taxes.[143] Under the present enactment it will generally be desirable to consider contemplation of death sales when the federal income tax rates of the person selling the property after the taxpayer's death are the same as or higher than the taxpayer's rates. Proposed modifications in the section 1023(c) basis adjustment for death taxes, discussed above, may limit or eliminate the present tax benefits of contemplation of death sales in many cases.

The potential for tax savings under the 1976 Act is illustrated by comparing a sale in contemplation of death with a sale immediately after death. Assume an unmarried taxpayer[144] (X) with a potential gross and taxable estate of $2,000,000. One asset (A), acquired in 1977, has always had a basis of $100,000 and it has a federal estate tax value of $600,000. Assume the sale of A for $600,000 will be made either by X or his executor and that in either case the capital gains federal income tax rate will be 35%.[145] It is assumed that no post-1976 taxable gifts have been made, that there are no estate tax deductions or credits other than the unified section 2010 credit, and that there are no state income or death taxes. X dies in 1981. If the sale were made immediately prior to death the total federal income and estate tax, based on present rules, would be $14,542 less than if the sale were made immediately after death by the executor. The computations are as follows:

	Sale by X (pre-death)	Sale by X's Executor
1. Income tax on gain from pre-death sale	$175,000[146]	——
2. Taxable estate	1,825,000[147]	$2,000,000
3. Estate tax after $47,000 credit	655,050	733,800
4. Income tax on gain from post-death sale	——	110,792[148]
5. Estate after income and estate taxes	$1,169,950	$1,155,408

[143] Compare this to the rules prior to the 1976 Act with respect to gifts made immediately before death where the gift taxes, unlike estate taxes, were not subject to federal estate tax. While gift taxes are now brought back into the estate on a gift just prior to death, *see* § 2035(c), income taxes on sales immediately prior to death are not, and hence are not subject to federal estate tax. It should be noted, however, that the federal income tax gain on a pre-death sale will be higher than on a post-death sale because on a pre-death sale the seller will not have the benefit of the basis adjustments of § 1023 in calculating gain.

[144] For a married taxpayer the lower marital deduction resulting from the effect of a pre-death non-installment sale on the value of the gross estate would reduce the immediate federal tax savings from a pre-death sale. *See* I.R.C. § 2056(a).

[145] For purposes of this discussion the minimum (§§ 56-58) and maximum (§ 1348) tax effect of the tax preference one half of capital gains is ignored. To the extent that a pre-death sale results in a loss of the benefits of the maximum tax on earned income, the tax benefits of a sale prior to death will be reduced.

[146] $600,000 (sales price) - $100,000 (basis) = $500,000 (gain) taxed at 35%.

[147] $2,000,000 - $175,000 (tax on sale).

[148] The basis would be $100,000 plus an estate tax adjustment for federal estate taxes of $183,450 [$500,000 (appreciation in A) /$2,000,000 (value of estate subject to federal estate

As an alternative to a pre-death sale with respect to which gain is recognized immediately, a pre-death installment sale might produce even greater tax benefits due to the income tax deduction allowed[149] for estate taxes on income in respect of a decedent. Taking the same example as before as an illustration, assume that the sale takes place immediately before death and that no gain on the sale is recognized until after death. Assuming further that the estate has ordinary income taxed at 70% which may be offset by the income in respect of a decedent deduction, the following table demonstrates the federal tax cost of using the installment sale approach:

	Sale by X on Installment Basis
1. Taxable estate	$2,000,000[150]
2. Estate tax after $47,000 credit	733,800
3. Income tax on gain from pre-death sale	175,000[151]
4. Income in respect of decedent deduction	183,450[152]
5. Tax saving from income in respect of decedent deduction (against 70% income)	128,415
6. Estate minus income and estate taxes (plus tax saving)	$1,219,615

Thus, as compared with a noninstallment sale, an installment sale would increase the tax saving by $49,665. The Technical Corrections Bill would prevent the use of the section 691 income in respect of a decedent deduction to offset income taxed at 70% but would allow it to be used to reduce the gain on the installment sale.[153] When the Technical Corrections Bill is passed the result of a pre-death installment sale will be the same as a post-death sale.

The area of contemplation of death sales is one that must be examined on a case by case basis, taking into account all of the estate and income tax variables as well as important nontax factors. If an estate's or beneficiary's income tax rates are low and the decedent's income tax rates are high, a contemplation of death sale may prove inadvisable. Moreover, if the taxpayer lives for a substantial period of time after the sale, the use of funds used to pay income taxes is lost. It is also, of course, crucial to determine whether the asset will be sold shortly after death. If it will not be sold, a contemplation of death sale may be unwise because of the loss of the use of funds unnecessarily used to pay income tax. Further, the impact of state income taxes on a pre-death versus post-death sale should be considered in light of the fact that some state statutes may be based on and continue to apply pre-1976 Act law[154] to allow a step-up basis to federal es-

tax) x $733,800 (estate tax) = $183,450] increasing the basis to $283,450 and reducing the gain to $316,550 ($600,000 - $283,450), subject to a 35% federal income tax.

[149] *See* I.R.C. § 691(c). This benefit would be precluded by the passage of the Technical Corrections Bill. See note 153 *infra.*

[150] No income tax on the sale is paid before death.

[151] This tax is the same as in the case of total recognition of gain prior to death.

[152] The calculation of that deduction is as follows: $500,000 (gain on sale)/$2,000,000 (value of estate) x $733,800 (federal estate tax) = $183,450. *See* I.R.C. § 691(c)(2)(C).

[153] H.R. 6715, 95th Cong., 1st Sess. § 3(b)(1977).

[154] *See, e.g.,* 1977 Mass. Adv. Legis. Serv. c. 599 § 10.

tate tax value on death, eliminating any post-death state income tax exposure on pre-death appreciation. The state tax factor might tip the balance in favor of not selling the asset before death. Where an individual has capital loss carryovers which expire on his death, it may be advisable to make contemplation of death sales, which would not result in any income tax to the extent that the gain is offset by prior capital losses.[155] Finally, tax shelter investments which have a negative value because of deferred income tax exposure might be sold or transferred prior to death to reduce the estate by the income taxes which would be due. The tax shelter probably could not be valued at below $0 in the estate so that a pre-death sale could generate a liability, reducing the estate, which would not otherwise exist. While this is clearly a complicated area, significant planning opportunities exist for those who are willing to analyze the various possibilities.

F. *Depreciation Recapture: Liabilities in Excess of Basis*

The carryover basis rules create planning problems with respect to ordinary income depreciation recapture and the timing of the recognition of gain from the transfer of property subject to liabilities in excess of its basis.[156]

1. Depreciation Recapture

Under prior law, because property received a new basis equal to its federal estate tax value at death, the ordinary income tax exposure resulting from the recapture of pre-death depreciation deductions on the sale or other disposition of property[157] was eliminated.[158] Under the carryover basis rules depreciated property that would have been subject to ordinary income recapture with respect to prior depreciation deductions when sold or disposed of before death will continue to be subject to recapture of pre-death depreciation upon a sale or other disposition by a person acquiring it from the decedent.[159]

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[155] Proposed legislation would allow unexpired net operating loss and capital loss carryforwards to be used by an estate after an individual's death. *See* S. 2228, 95th Cong., 1st Sess. (1977). The Treasury supports this proposal in a modified form with respect to capital loss carryforwards. *See* Statement of Donald C. Lubick, *supra* note 42 at J-8. If this proposal becomes law, the problem of the loss of the use of tax shelter deductions (because of too low a basis under the at risk rules) might be avoided or, at the very least, the "trapped deductions" might shelter the gain on a sale of the property or partnership interest by the estate since, for example, in the case of a partnership, the basis of the partnership interest would have been reduced, *see* I.R.C. § 705, whether or not the loss was deductible under § 704(d).

[156] These issues will often arise in the context of tax shelters, to the extent that tax shelters are still viable after the 1976 Act.

[157] I.R.C. §§ 1245, 1250.

[158] Generally, a transfer at death does not cause recognition of § 1245 or § 1250 depreciation recapture ordinary income. *See* I.R.C. §§ 1245(b)(2), 1250(d)(2). Treas. Regs. §§ 1.1245-2(c)(1)(iv) (1971), 1.1250-3(b)(2) (1976), indicate that under pre-1976 Act law the pre-death depreciation basis adjustments were not reflected in the basis of property acquired at death because of the step-up or step-down in basis to federal estate tax value. *See* I.R.C. §§ 1245(a)(2), 1250(a). Thus, no ordinary income recognition of pre-death depreciation deductions occurred in a post-death sale.

[159] Investment credit recapture still should be avoided. Section 47(b) indicates that such recapture does not apply to a transfer by reason of death without regard to a step-up or car-

The Joint Committee Explanation indicates that this "potential depreciation recapture is to be passed through to the beneficiary who receives the property" when property subject to recapture passes to an estate on death.[160] Presumably pre-1976 Act law will be followed in this regard. Under pre-1976 Act law there was often no recapture of depreciation deductions taken by the estate when property was distributed by the estate to a beneficiary.[161] This was not true, however, when property distributed carried out distributable net income. In that case the estate was forced to recognize depreciation recapture when the property was distributed.[162] Similarly, when property subject to recapture was used to satisfy a pecuniary bequest, the recapture income was recognized by the estate since if it were not recognized at that time it would never be recognized.

One of the as yet unresolved issues arising from the 1976 Act is the application of the fresh start adjustment in reducing potential depreciation recapture. For example, assume that section 1245 depreciable property with an original basis of $50, an adjusted basis immediately prior to death of $10, and a basis after all adjustments under section 1023 of $60, is sold by an estate immediately after death for $120 at a $60 gain. If the property was held for the same amount of time before January 1, 1977 as thereafter and was depreciated on a straight-line basis, then section 1023(h) would seem to indicate that one half of the pre-death depreciation taken or $20, should be allocated to the pre-1977 period and the tax basis of the property stepped up accordingly. The $20 fresh start adjustment for pre-1977 depreciation should not simply reduce the total gain on the sale in the example above but rather, should specifically reduce that part of the gain which is treated as depreciation recapture ordinary income. Only the post-1976 portion of the depreciation taken ($20) should be treated as ordinary income depreciation recapture on a sale netting a $60 gain. This position is supported by the fact that pre-1977 depreciation will not be reflected in the basis of the property because of the section 1023 fresh start adjustment. Thus, if the taxpayer is to receive the benefits of prior law through 1976, the result must be as outlined.

2. Liabilities in Excess of Basis

Under general tax principles when a taxpayer transfers property, even if the transfer is by gift, and a mortgage on the property exceeds the property's tax basis, the taxpayer should recognize gain measured by the difference between the mortgage and the basis.[163] Similarly, where a lim-

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ryover basis. *See* Treas. Reg. § 1.47-3(b)(1) (1972) (at death property qualifying for an investment credit deemed held for entire useful life thereby eliminating recapture of investment credit).

[160] STAFF OF THE JOINT COMMITTEE ON TAXATION, 94TH CONG., 2d SESS., GENERAL EXPLANATION OF THE TAX REFORM ACT OF 1976, at 555 (Comm. Print 1976), *reprinted in* 1976-3 vol. 2 C.B. 1, 567.

[161] *See* Treas. Regs. §§ 1.1245-4 (a) (1972), 1.1250-3(a)(1) (1976).

[162] *See generally* Horvitz, *Depreciation Recapture–Transfers by Gift, Death and Taxfree Rollover*, 169-2nd TAX MANAGEMENT A1, A20-A28, BNA 1975. Since the beneficiary received a stepped-up basis equal to the income distributed, if the depreciation recapture was not recognized at that time it would never be recognized. Rev. Rul. 64-314, 1964-2 C.B. 167.

[163] Treas. Reg. § 1.1001-1(e) (1972); Crane v. Commissioner, 331 U.S. 1 (1947); Johnson v. Commissioner, 59 T.C. 791 (1973), *aff'd*, 495 F.2d 1079 (6th Cir. 1974), *cert. denied*, 419 U.S. 1040 (1974) (gift property).

ited partnership interest is transferred during a taxpayer's life, he will be treated as having been relieved of his share of partnership liabilities, and to the extent that those liabilities exceed his basis in his partnership interest gain will be recognized.[164] Despite these general rules, prior to the 1976 Act it was generally assumed that a transfer at death did not constitute a taxable disposition. This appeared to be the rule even where the liabilities exceeded the basis of the property transferred.

The 1976 Act should not affect the rules in this area and the income tax treatment with respect to the decedent-transferor. This is so because the 1976 Act only affects the basis of persons acquiring property from the decedent and not of the decedent himself. Under pre-1976 Act law it was the person acquiring property from the decedent and not the decedent who received a federal estate tax value basis on death.[165] The new carryover basis rules should not result in the decedent's recognizing gain which would not have been recognized under prior law on a transfer at death. This position might be viewed as consistent with the Joint Committee Explanation, indicating that only the disposition of property by the ultimate beneficiary will trigger depreciation recapture income (presumably because of the carryover basis).[166] However, a different approach might be taken, by drawing an analogy to the rules applicable in the gift area, since the carryover basis rules under section 1023 are, in large part, parallel to the gift rules. If this analogy were made, a transfer at death of property subject to liabilities in excess of tax basis would become a taxable event similar to the making of a gift and gain would be recognized on the transfer.[167]

Assuming that it is determined that there is no recognition in the decedent's last income tax return or the estate's first income tax return of the excess of liabilities over the basis of carryover basis property on a transfer at death, an issue arises as to what disposition will trigger an income tax. For instance, if property passing from a decedent to his executor were subject to liabilities of $100 and had a basis of $10 and his executor transferred the property to a beneficiary, it might be argued that the executor should recognize gain equal to the difference between the liabilities and the tax basis at the time of the transfer to the beneficiary. There is no clear authority in this area since typically under prior law the step-up in basis to federal estate tax value at death increased the basis so that it equalled or exceeded the liabilities on the property. Arguably, the regulations, by analogy to the depreciation recapture rules, might provide that the gain would be recognized only on a disposition by the ultimate beneficiary so long as the ultimate beneficiary's basis was determined by reference to that of the executor. Because of uncertainty in this area it might be desirable, where possible, to pass property directly to a beneficiary, either through joint

[164] *See* I.R.C. § 752(b); Rev. Rul. 75-194, 1975-1 C.B. 80 (when a limited partnership interest is transferred to charity, part of the basis could be allocable to a gift, increasing gain).

[165] *See* I.R.C. § 1014(a).

[166] STAFF OF THE JOINT COMMITTEE ON TAXATION, 94TH CONG., 2d SESS., GENERAL EXPLANATION OF THE TAX REFORM ACT OF 1976 at 555 (Comm. Print 1976), *reprinted in* 1976-3 Vol. 2 C.B. 1, 567.

[167] *See* Treas. Reg. § 1.1001-1(e) (1972). There would appear to be specific statutory authority under § 752(b) for imposing an income tax at death on the transfer of a partnership interest from the decedent to an heir where the deceased partner's share of liabilities exceeds his basis in his interest. However, there are no pre-1976 Act cases suggesting that an income tax has been imposed under these circumstances.

ownership or otherwise, so that the question of whether an income tax results on a distribution from an estate would never arise.

A further problem arises for the ultimate beneficiary who may be required to recognize the gain on disposition of an asset with liabilities in excess of basis. Assume that property with an adjusted basis after section 1023 adjustments of $30,000 and a value of $100,000, subject to a nonrecourse mortgage of $80,000, is transferred on death from the decedent to a beneficiary. If the beneficiary sells the property subject to the mortgage for $20,000, the beneficiary will be treated as having received $100,000: $20,000 in cash and relief from an $80,000 mortgage.[168] There will be a $70,000 gain on the sale resulting from the difference between the $100,000 received and the $30,000 basis. If the beneficiary's marginal rate is 35% for long-term capital gains, the federal income tax on the sale would be $24,500 (35% X $70,000) ignoring any additional minimum or maximum tax impact of the sale. Thus, the actual cash received by the beneficiary, $20,000, would be less than the $24,500 tax liability resulting from the transfer. This would suggest, in many cases, that it is undesirable to transfer property containing inherent liabilities to beneficiaries or, if such property is transferred, that it may be desirable for the beneficiary to disclaim in a timely manner all his or her rights in it.[169] The disclaimer should meet the requirements of section 2518 and any appropriate state laws to assure its effectiveness for federal estate and gift tax purposes since the disclaiming party may not maintain an interest (under state law) in the property disclaimed.[170]

Because of the possibility that tax liabilities might exceed any cash received by the beneficiary on a sale of property subject to liabilities in excess of basis, it has been suggested that such property be transferred to charities on death.[171] While unrelated business income of a charity is not exempt from income tax, the charity should not, under present law, face the same problems as other beneficiaries with respect to the recognition of income on a sale of the property. This is because property subject to mortgage indebtedness which is bequeathed to a charity will not be treated as subject to acquisition indebtedness for ten years and might be sold by the charity within ten years without federal income tax exposure.[172] In the example above the charity would net $20,000 on the sale and, no doubt, be delighted to receive the bequest and would not disclaim it. A transfer at death to a United States possession or the United States government of property generating cash might also be successful if it does not result in a disclaimer.[173] The problems in this area should be examined on a case by case

[168] *See* Crane v. Commissioner, 331 U.S. 1 (1947).

[169] If such property is part of the marital deduction trust there is a question as to how it will be valued, given the inherent liability. See note 77 *supra*.

[170] *See* I.R.C. § 2518.

[171] This approach might, however, lead to recognition of gain through the application of Rev. Rul, 75-194, 1975-1 C.B. 80.

[172] *See* I.R.C. §§ 512(a), (b)(4) dealing with unrelated business income of a charity. Further, § 514 sets forth various rules with respect to debt-financed property. *See* § 514(c)(2)(B)

[173] The United States government may disclaim if the tax revenues generated would be increased. A United States possession, which is not taxable on the income from the property, may have no incentive to disclaim unless the United States government exerts pressure on the possession. *See* I.R.C. § 115(a)(2).

basis. Perhaps the property should be bequeathed to an individual, in case it turns out to be valuable, with a contingent bequest to a charity should the individual disclaim the property.[174]

G. *Entity v. Cross-Purchase Agreements*

Stock of a closely-held corporation is often subject to a buy-back agreement to assure retention of control by a certain group of shareholders. Pursuant to an entity buy-back agreement, the corporation itself purchases the stock of a deceased shareholder on his death. An alternative to an entity buy-back agreement is a cross-purchase agreement, whereby the other shareholders individually purchase the stock of a deceased shareholder in proportion to their shareholdings on his death. Typically, the entity purchase agreement approach has been used because of administrative simplicity and because it can be funded out of corporate, rather than personal, funds.

A simple and economic method for effecting an entity purchase agreement which assures that adequate cash will be available when necessary for stock purchases is to fund the purchase of each shareholder's stock by life insurance. If a cross-purchase agreement is funded by life insurance, each individual shareholder must purchase insurance on each of the other shareholders' lives in proportion to his stockholdings, using his after-tax dollars to do so. Income tax problems often arise with respect to transfers for value of life insurance policies funding a cross-purchase agreement, particularly after a shareholder's death, since it may be desirable to transfer the policies on the lives of the other shareholders held by him.[175] An entity buy-back agreement is not subject to these transfer for value problems. This is another reason why the entity buy-back agreement was generally preferred under pre-1976 Act law.

The new carryover basis rules, however, may make it more desirable in certain cases to use the cross-purchase approach rather than the entity purchase approach.[176] For example, assume a corporation with two shareholders. The basis of the stock of each shareholder, purchased in 1977, is $1,000 and its value in 1980 is $100,000. If one shareholder were to die, under an entity purchase approach the remaining shareholder would continue to have a basis of $1,000 for his shares after the corporation redeemed the stock owned by the deceased shareholder. However, under a

[174] Given the results discussed in the text, and the possibility that the property could pass to a charity without any ultimate recapture, it would probably be desirable administratively to tax the transfer from the decedent at death where the liabilities with respect to the property transferred exceed its basis. There is no statutory provision prohibiting a tax at that time, and the analogy to a gift might be made although an involuntary conversion of all property at death can be distinguished from a gift of specific property. If a tax is imposed at death this will increase the liquidity needs of the estate.

[175] *See* I.R.C. § 101. These problems could result in the proceeds received on death being, in part, taxable rather than taxfree. *See* S. 2461, 95th Cong., 2d Sess. (1978) (allowing certain transfers of policies from a corporation to a shareholder as part of a switch from an entity to a cross-purchase approach without problems arising from transfers for value).

[176] The cross-purchase approach might be converted to the entity approach at any time where necessary by the simple expedient of a contribution of the insurance policies to the capital of the corporation. No transfer for value problems should be created unless the shareholders are viewed as making an exchange. *See* I.R.C. § 101(a)(2)(B).

cross-purchase approach the remaining shareholder would have a basis of $101,000 for his shares. This is because he would have paid $100,000 to the deceased shareholder's estate in exchange for the shares held by it. The $100,000 would have been received free of federal income tax as insurance proceeds[177] by the surviving shareholder. This step-up in basis would reduce the gain realized by the surviving shareholder if he were to sell his shares or if the corporation were to be liquidated, whether prior to or after his death. Under prior law, since basis was stepped-up to federal estate tax value at death, there was no need to rely on a cross-purchase approach to step-up the basis of a surviving shareholder's stock to reduce the income tax exposure on a post-death sale. Accordingly, a step-up in basis was not a significant factor considered in deciding between a cross-purchase and entity purchase.

While the cross-purchase agreement funded by life insurance may look preferable to an entity agreement because of the new carryover basis rules, a closer examination might indicate that an entity purchase approach still should be used. This is because a cross-purchase approach requires that after-tax dollars in the hands of the shareholders be used to pay annual premiums for insurance. Assuming the shareholders can receive these additional dollars through salary distributions from the corporation, taxable to them at a maximum rate of 50% (assuming no tax preference items and ignoring state taxes), the fact that after-tax dollars are used might not be overly significant. The shareholders would receive additional salary equal to the premiums to be paid plus the taxes on the additional salary so that paying the premiums would not require them to use other funds. The corporation could then take a deduction for the amount paid to the shareholders as additional salary if that amount of compensation were reasonable and did not constitute a return to the shareholders on the capital of the corporation. This deduction would be worth approximately 50% of the amount paid by the corporation as additional salary.[178]

If an entity approach were used and the corporation paid one half of the amount paid out in salary under a cross-purchase approach to pay the insurance premiums, the corporation would be out approximately the same number of dollars as it would have been under the cross-purchase approach, since the money used to pay the premiums would not be deductible.[179] The shareholders would also be in the same cash position as under an entity purchase approach. However, if the additional amounts paid out to the shareholders under a cross-purchase approach to fund their purchase of life insurance and to pay their taxes were treated as dividends, the cross-purchase approach would have a significant undesirable income tax impact as compared with the income tax impact of paying premiums under the entity approach since the amounts paid to the shareholders would be subject to taxation at both the corporate and shareholder levels (assuming the corporation is not a subchapter S corporation). Since a dividend risk is always present, particularly if the shareholders are taking the maximum amount possible from a successful corporation as salary to provide for their cash needs, it still may be desirable to use the entity approach.

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[177] *See* I.R.C. § 101.

[178] The income tax on corporate earnings in excess of $50,000 is presently 48%. I.R.C. §§ 11(b),(c),(d). Deducting from its income the salary paid could therefore represent a tax savings of approximately one half of the salary.

[179] *See* I.R.C. § 264.

H. *State Law*

In any consideration of the impact of carryover basis rules, the relevant state income tax laws should be examined. Some states, such as Massachusetts, may continue to provide that for purposes of making various income tax calculations the principles of the Internal Revenue Code as it existed prior to the 1976 Act are applicable.[180] Consequently, a federal estate tax value step-up or step-down basis may still exist in some states on death, contrary to federal law. The impact of state taxes must be considered in making any tax planning decision.

I. *Miscellaneous*

There are, of course, many other situations where the impact of the carryover basis rules must be considered. For example, where stock subject to a fresh start adjustment is to be sold by a taxpayer in the context of a corporate acquisition, he may wish to ensure that the acquisition be tax-free in order that the fresh start adjustment not be lost. Alternatively, in a taxable acquisition an elderly shareholder may wish to sell assets and keep the corporation alive as a personal holding company, investing in municipals to eliminate the personal holding company tax.[181] After his death a substantial fresh start adjustment would allow his estate to liquidate the corporation without a significant income tax.

Numerous matters must also be considered in the context of determining which assets to distribute to each beneficiary of an estate, taking into account their income tax brackets and the like, and which assets to sell to pay death taxes and administration expenses. Consideration should also be given to when it is desirable, because of relative income tax brackets, for an estate to sell assets and distribute cash rather than to distribute assets which are sold shortly thereafter. Further, consideration must be given to state law governing the administration of estates and the executor's fiduciary responsibilities as to fairness and impartiality regarding beneficiaries. These fiduciary rules, unless provision is otherwise made in the relevant instruments, may affect the ability of an executor to exercise unfettered discretion in determining which assets with low or high bases should be distributed to each beneficiary.

One thing that can be stated with certainty is that the carryover basis rules will require detailed record keeping as to the tax basis of all property. Moreover, under the 1976 Act, income tax gains on post-death sales of carryover basis property may be modified by even a slight change in values on the audit of an estate tax return, affecting the section 1023(c) basis adjustment and the like.[182] Therefore, until legislative proposals changing the method of calculating the section 1023(c) basis adjustment are passed, it will be important that income tax refund claims be appropriately filed.

[180] *See* 1977 Mass. Adv. Legis. Serv. c. 599 § 10.

[181] *See* I.R.C. § 545 (defining undistributed personal holding company income). *See also* § 535 (defining accumulated taxable income).

[182] Valuation changes have this effect because adjustments are presently determined on the basis of average and not marginal rates (which slight valuation changes of some assets would not affect).

Further, clients should no doubt be advised that in determining bequests of appreciated property to be made by them, the reduction in value because of the income tax cost to the beneficiary should be considered.[183]

CONCLUSION

The new carryover basis rules create many technical complexities and planning problems. They also offer new planning opportunities. Care must be taken in each situation to obtain, consistent with non-tax objectives, the maximum tax benefits of these new rules as they may be modified by future legislation. Until regulations are issued and anticipated modifications or adjustments of the provisions of the 1976 Act are made within the next few years, cautious tax planning will be required.

The new rules equitably prevent unrealized appreciation in assets from escaping income tax altogether (unlike the pre-1976 Act rules) and treat transfers at death in a fashion similar to the treatment of transfers by gift, consistent with the notion that neither should be treated as a taxable transfer. However, given the fact that high administration costs may exceed the revenue gains, it is possible that the carryover basis rules, while equitable, might be repealed. If carryover basis rules are to be effective and their repeal avoided, regulations not only must implement their technical provisions but also must provide practical guidance in their administration.

Some support now exists in Congress for either returning to the old section 1014 rules or, alternatively, recognizing unrealized gain or loss in assets on death while concomitantly adjusting the basis of property to federal estate tax value. While both approaches would avoid some of the administrative complexities of the carryover basis rules,[184] with which no one has had any experience, the second approach, a tax on transfers at death, would impose liquidity hardships on many estates.[185]

The first approach, returning to the old section 1014 rules, may not be viable without a plethora of other changes (including among others a change of the unified credit) because the increase in tax revenues from the switch to carryover basis rules was intended to offset revenue losses from the liberalization of various estate tax provisions under the 1976 Act. In any event, if the carryover basis rules are not repealed, it is likely that various modifications will be made to reduce the complexities of the new rules, including a modification which would increase the minimum basis adjustment to $175,000 and would change the order of the section 1023 adjustments. It cannot be expected that the present provisions governing carryover basis will survive as the permanent rules. Any carryover basis tax planning thus requires constant attention not only to the 1976 Act, but also to any future legislative developments.

[183] *See* I.R.C. § 663(a)(1).

[184] A tax at death would also require knowledge of the basis of assets, part of the underlying complexity of the § 1023 rules.

[185] These liquidity hardships would exist even after taking into account the inevitable exceptions to a tax on transfers at death, such as an exception for a principal residence (with a dollar limit).